

CORTLAND BANCORP INC  
Form 10-Q  
November 10, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 0-13814

Cortland Bancorp

(Exact name of registrant as specified in its charter)

Ohio	34-1451118
(State or other jurisdiction of	(I.R.S. Employer
Incorporation or organization)	Identification No.)
194 West Main Street, Cortland, Ohio	44410
(Address of principal executive offices)	(Zip code)

330- 637-8040

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(Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "accelerated filer and large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

TITLE OF CLASS	SHARES OUTSTANDING
Common Stock, No Par Value	4,420,255 Shares November 3, 2016



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## CORTLAND BANCORP AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(Amounts in thousands, except share data)

	September 30, 2016	December 31, 2015
<b>ASSETS</b>		
Cash and due from banks	\$ 7,944	\$ 8,454
Interest-earning deposits	14,343	10,042
Total cash and cash equivalents	22,287	18,496
Investment securities available-for-sale (Note 3)	164,138	153,901
Trading securities (Note 3)	—	8,134
Loans held for sale	4,039	4,033
Total loans (Note 4)	395,763	394,254
Less allowance for loan losses (Note 4)	(4,915 )	(5,194 )
Net loans	390,848	389,060
Premises and equipment	8,916	9,190
Bank-owned life insurance	17,301	17,328
Other assets	13,633	12,301
Total assets	\$ 621,162	\$ 612,443
<b>LIABILITIES</b>		
Noninterest-bearing deposits	\$ 112,996	\$ 108,144
Interest-bearing deposits	395,456	388,260
Total deposits	508,452	496,404
Short-term borrowings	2,313	2,499
Federal Home Loan Bank advances - short term	14,000	17,000
Federal Home Loan Bank advances - long term	20,500	25,000
Subordinated debt (Note 7)	5,155	5,155
Other liabilities	10,408	9,701
Total liabilities	560,828	555,759
<b>SHAREHOLDERS' EQUITY</b>		
Common stock - \$5.00 stated value - authorized 20,000,000 shares; issued	23,641	23,641

4,728,267 shares in 2016  
and 2015; outstanding

shares, 4,420,255 in 2016

and 4,404,783 in 2015

Additional paid-in capital	20,860	20,833
Retained earnings	20,654	17,851
Accumulated other comprehensive income (loss)	552	(238 )
Treasury stock, at cost, 308,012 shares in 2016 and 323,484 in 2015	(5,373 )	(5,403 )
Total shareholders' equity	60,334	56,684
Total liabilities and shareholders' equity	\$ 621,162	\$ 612,443

See accompanying notes to the unaudited consolidated financial statements of Cortland Bancorp and Subsidiaries

## CORTLAND BANCORP AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

(Amounts in thousands, except per share data)

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	SEPTEMBER		SEPTEMBER 30,	
	30,	2015	2016	2015
	2016	2015	2016	2015
<b>INTEREST INCOME</b>				
Interest and fees on loans	\$4,705	\$4,282	\$13,811	\$12,547
Interest and dividends on investment securities:				
Taxable interest	470	547	1,531	1,765
Nontaxable interest	451	434	1,332	1,302
Dividends	23	28	86	91
Other interest income	11	4	33	13
Total interest income	5,660	5,295	16,793	15,718
<b>INTEREST EXPENSE</b>				
Deposits	535	412	1,537	1,227
Short-term borrowings	2	1	5	3
Federal Home Loan Bank advances - short term	19	11	52	29
Federal Home Loan Bank advances - long term	159	202	479	602
Subordinated debt	28	23	81	67
Total interest expense	743	649	2,154	1,928
Net interest income	4,917	4,646	14,639	13,790
<b>PROVISION FOR LOAN LOSSES</b>	50	100	50	390
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	4,867	4,546	14,589	13,400
<b>NON-INTEREST INCOME</b>				
Fees for customer services	538	522	1,570	1,491
Investment securities available-for-sale gains (losses), net	83	(3 )	458	(3 )
Trading security gains (losses), net	—	50	(47 )	20
Mortgage banking gains, net	341	291	1,155	636
Earnings on bank-owned life insurance	80	83	253	255
Wealth management income	10	56	50	363
Other non-interest income	68	47	253	197
Total non-interest income	1,120	1,046	3,692	2,959
<b>NON-INTEREST EXPENSES</b>				
Salaries and employee benefits	2,633	2,163	7,626	6,999
Net occupancy and equipment expense	532	509	1,595	1,501
State and local taxes	122	100	347	304
FDIC insurance expense	54	70	220	236
Professional fees	198	207	685	613
Advertising and marketing expense	130	130	402	265
Net losses from the extinguishment of debt	—	—	242	—
Other operating expenses	810	811	2,580	2,253



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Total non-interest expenses	4,479	3,990	13,697	12,171
INCOME BEFORE FEDERAL INCOME TAX EXPENSE	1,508	1,602	4,584	4,188
Federal income tax expense	313	375	854	896
NET INCOME	\$1,195	\$1,227	\$3,730	\$3,292
EARNINGS PER SHARE BASIC AND DILUTED	\$0.27	\$0.27	\$0.85	\$0.73
CASH DIVIDENDS DECLARED PER SHARE	\$0.07	\$0.06	\$0.21	\$0.18

See accompanying notes to the unaudited consolidated financial statements of Cortland Bancorp and Subsidiaries

## CORTLAND BANCORP AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (UNAUDITED)

(Amounts in thousands)

	THREE MONTHS ENDED		NINE MONTHS ENDED	
	SEPTEMBER 30,		SEPTEMBER 30,	
	2016	2015	2016	2015
Net income	\$1,195	\$1,227	\$3,730	\$3,292
Other comprehensive (loss) income:				
Securities available for sale:				
Unrealized holding (losses) gains on available-for-sale securities	(839 )	967	1,599	(121 )
Tax effect	286	(328 )	(544 )	41
Reclassification adjustment for net (gains) losses realized in net income	(83 )	3	(458 )	3
Tax effect	28	(1 )	156	(1 )
Total securities available for sale	(608 )	641	753	(78 )
Change in post-retirement obligations	12	(23 )	37	(68 )
Total other comprehensive (loss) income	(596 )	618	790	(146 )
Total comprehensive income	\$599	\$1,845	\$4,520	\$3,146

See accompanying notes to the unaudited consolidated financial statements of Cortland Bancorp and Subsidiaries

## CORTLAND BANCORP AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (UNAUDITED)

(Amounts in thousands, except per share data)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
<b>NINE MONTHS ENDED September 30, 2015</b>						
Balance at December 31, 2014	\$ 23,641	\$ 20,833	\$ 14,555	\$ 376	\$ (3,553 )	\$ 55,852
Net income	—	—	3,292	—	—	3,292
Other comprehensive loss	—	—	—	(146 )	—	(146 )
Cash dividend declared (\$0.18 per share)	—	—	(815 )	—	—	(815 )
Treasury shares purchased net of 1 share reissued (64,904 shares)	—	—	—	—	(948 )	(948 )
Balance at September 30, 2015	\$ 23,641	\$ 20,833	\$ 17,032	\$ 230	\$ (4,501 )	\$ 57,235
<b>NINE MONTHS ENDED September 30, 2016</b>						
Balance at December 31, 2015	\$ 23,641	\$ 20,833	\$ 17,851	\$ (238 )	\$ (5,403 )	\$ 56,684
Net income	—	—	3,730	—	—	3,730
Other comprehensive income	—	—	—	790	—	790
Cash dividend declared (\$0.21 per share)	—	—	(927 )	—	—	(927 )
Equity compensation	—	27	—	—	30	57
Balance at September 30, 2016	\$ 23,641	\$ 20,860	\$ 20,654	\$ 552	\$ (5,373 )	\$ 60,334

See accompanying notes to the unaudited consolidated financial statements of Cortland Bancorp and Subsidiaries

## CORTLAND BANCORP AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(Amounts in thousands)

	FOR THE NINE MONTHS	
	ENDED SEPTEMBER 30,	
	2016	2015
Net cash flow from operating activities	\$ 11,562	\$ 793
Cash (deficit) flow from investing activities		
Purchases of available-for-sale securities	(69,379)	(13,225)
Proceeds from sale of available-for-sale securities	44,374	7,655
Proceeds from call, maturity and principal payments on available-for-sale securities	15,716	14,631
Net increase in loans made to customers	(1,885 )	(127 )
Proceeds from sale of other real estate	64	40
Proceeds from bank-owned life insurance	280	—
Purchases of premises and equipment	(376 )	(2,069 )
Net cash (deficit) flow from investing activities	(11,206)	6,905
Cash flow (deficit) from financing activities		
Net increase (decrease) in deposit accounts	12,048	(2,214 )
Net change in short term borrowings	(186 )	(2,540 )
Net change in Federal Home Loan Bank advances - short term	(3,000 )	2,500
Repayments of Federal Home Loan Bank advances - long term	(6,500 )	(4,000 )
Proceeds from Federal Home Loan Bank advances - long term	2,000	4,000
Dividends paid	(927 )	(815 )
Treasury shares purchased	—	(948 )
Net cash flow (deficit) from financing activities	3,435	(4,017 )
Net change in cash and cash equivalents	3,791	3,681
Cash and cash equivalents		
Beginning of period	18,496	10,569
End of period	\$ 22,287	\$ 14,250
Supplemental disclosures:		
Cash paid during the period for:		
Income taxes	\$ 525	\$ 910
Interest	\$ 2,123	\$ 1,937
Transfer of loans to other real estate owned	\$ 47	\$ 62

See accompanying notes to the unaudited consolidated financial statements of Cortland Bancorp and Subsidiaries



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1.) Basis of Presentation and Reclassifications:

The accompanying unaudited consolidated financial statements of Cortland Bancorp (the Company) and the Cortland Savings and Banking Company (the Bank) have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring items) considered necessary for a fair presentation have been included. Operating results for the nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. These interim unaudited consolidated financial statements should be read in conjunction with our annual audited financial statements as of December 31, 2015, included in our Form 10-K for the year ended December 31, 2015, filed with the United States Securities and Exchange Commission. The accompanying consolidated balance sheet at December 31, 2015, has been derived from the audited consolidated balance sheet but does not include all of the information and footnotes required by U.S. GAAP for complete financial statements.

Certain items contained in the 2015 financial statements have been reclassified to conform to the presentation for 2016. Such reclassifications had no effect on the net results of operations or shareholders' equity.

2.) Authoritative Accounting Guidance:

In January 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This Update applies to all entities that hold financial assets or owe financial liabilities and is intended to provide more useful information on the recognition, measurement, presentation, and disclosure of financial instruments. Among other things, this Update (a) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (g) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (h) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For

all other entities including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. All entities that are not public business entities may adopt the amendments in this Update earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which: (a) the lease term is 12 months or less, and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. This Update is not expected to have a significant impact on the Company's financial statements.

In March 2016, the FASB issued ASU 2016-05, Derivatives and Hedging (Topic 815). The amendments in this Update apply to all reporting entities for which there is a change in the counterparty to a derivative instrument that has been designated as a heading

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

instrument under Topic 815. The standards in this Update clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under Topic 815 does not, in and of itself, require designation of that hedging relationship provided that all other hedge accounting criteria continue to be met. For public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For all other entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. An entity has an option to apply the amendments in this Update on either a prospective basis or a modified retrospective basis. Early adoption is permitted, including adoption in an interim period. This Update is not expected to have a significant impact on the Company's financial statements.

In March 2016, the FASB issued ASU 2016-06, Derivatives and Hedging (Topic 815). The amendments apply to all entities that are issuers of or investors in debt instruments (or hybrid financial instruments that are determined to have a debt host) with embedded call (put) options. The amendments in this update clarify the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt host. An entity performing the assessment under the amendments in this Update is required to assess the embedded call (put) options solely in accordance with the four-step decision sequence. For public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For entities other than public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. This Update is not expected to have a significant impact on the Company's financial statements.

In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606). The amendments in this Update affect entities with transactions included within the scope of Topic 606, which includes entities that enter into contracts with customers to transfer goods or services (that are an output of the entity's ordinary activities) in exchange for consideration. The amendments in this update do not change the core principle of the guidance in Topic 606; they simply clarify the implementation guidance on principal versus agent considerations. The amendments in this Update are intended to improve the operability and understandability of the implementation guidance on principal versus agent considerations. The amendments in this Update affect the guidance in ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements of Update 2014-09. ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, defers the effective date of Update 2014-09 by one year. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In March 2016, the FASB issued ASU 2016-09, Compensation – Stock Compensation (Topic 718). The amendments in this Update affect all entities that issue share-based payment awards to their employees. The standards in this Update provide simplification for several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as with equity or liabilities, and classification on the statement of



cash flows. Some of the areas for simplification apply only to nonpublic entities. In addition to those simplifications, the amendments eliminate the guidance in Topic 718 that was indefinitely deferred shortly after the issuance of FASB Statement No. 123 (revised 2004), Share-Based Payment. This should not result in a change in practice because the guidance that is being superseded was never effective. For public business entities, the amendments in this Update are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted for any entity in any interim or annual period. This Update is not expected to have a significant impact on the Company's financial statements.

In April 2016, the FASB issued ASU 2016-10, Revenue from Contracts with Customers (Topic 606). The amendments in this Update affect entities with transactions included within the scope of Topic 606, which includes entities that enter into contracts with customers to transfer goods or services in exchange for consideration. The amendments in this Update do not change the core principle for revenue recognition in Topic 606. Instead, the amendments provide (1) more detailed guidance in a few areas and (2) additional implementation guidance and examples based on feedback the FASB received from its stakeholders. The amendments are expected to reduce the degree of judgment necessary to comply with Topic 606, which the FASB expects will reduce the potential for diversity arising in practice and reduce the cost and complexity of applying the guidance. The amendments in this Update affect the guidance in ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements in Topic 606 (and any other Topic amended by Update 2014-09). ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, defers the effective date of Update 2014-09 by one year. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

In May 2016, the FASB issued ASU 2016-11, Revenue Recognition (Topic 605) and Derivative and Hedging (Topic 815), which rescinds SEC paragraphs pursuant to two SEC Staff Announcements at the March 3, 2016, Emerging Issues Task Force meeting. This Update did not have a significant impact on the Company's financial statements.

In May 2016, the FASB issued ASU 2016-12, Revenue from Contracts with Customers (Topic 606), which among other things clarifies the objective of the collectability criterion in Topic 606, as well as certain narrow aspects of Topic 606. The amendments in this Update affect the guidance in ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements for Topic 606 (and any other Topic amended by Update 2014-09). ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, defers the effective date of Update 2014-09 by one year. This Update is not expected to have a significant impact on the Company's financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments-Credit Losses: Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"), which changes the impairment model for most financial assets. This ASU is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The underlying premise of the ASU is that financial assets measured at amortized cost should be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The allowance for credit losses should reflect management's current estimate of credit losses that are expected to occur over the remaining life of a financial asset. The income statement will be effected for the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2019, and early adoption is permitted for annual and interim periods beginning after December 15, 2018. With certain exceptions, transition to the new requirements will be through a cumulative effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the guidance is adopted. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"), which addresses eight specific cash flow issues with the objective of reducing diversity in practice. Among these include recognizing cash payments for debt prepayment or debt extinguishment as cash outflows for financing activities; cash proceeds received from the settlement of insurance claims should be classified on the basis of the related insurance coverage; and cash proceeds received from the settlement of bank-owned life insurance policies should be classified as cash inflows from investing activities while the cash payments for premiums on bank-owned policies may be classified as cash outflows for investing activities, operating activities, or a combination of investing and operating activities. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that

elects early adoption must adopt all of the amendments in the same period. The amendments in this Update should be applied using a retrospective transition method to each period presented. If it is impracticable to apply the amendments retrospectively for some of the issues, the amendments for those issues would be applied prospectively as of the earliest date practicable. The Company is currently evaluating the impact the adoption of the standard will have on the Company's statement of cash flows.

### 3.) Investment Securities:

Investments in debt and equity securities are classified as held-to-maturity, available-for-sale or trading. Securities classified as held-to-maturity are those that management has the positive intent and ability to hold to maturity. Securities classified as available-for-sale are those that could be sold for liquidity, investment management, or similar reasons, even though management has no present intentions to do so. Securities classified as trading are those that management has bought principally for the purpose of selling in the near term. The Company currently has no securities classified as held-to-maturity or trading.

Available-for-sale securities, other than regulatory stock, are carried at fair value with unrealized gains and losses recorded as a separate component of shareholders' equity, net of tax. Realized gains or losses on dispositions are based on net proceeds and the adjusted carrying amount of securities sold, using the specific identification method. Interest income includes amortization of purchase premium or discount and is amortized on the level-yield method without anticipating payments, except for U.S. Government mortgage-backed and related securities where twelve months of historical prepayments are taken into consideration. Trading securities are carried at fair value with valuation adjustments included in other non-interest income.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The regulatory stock is carried at cost (its redeemable value) and the Company is required to hold such investments as a condition of membership in order to transact business with the Federal Home Loan Bank (FHLB) of Cincinnati and the Federal Reserve Bank (FRB). The stock is bought from and sold to the correspondent institutions based upon its par value. The stock cannot be traded or sold in any market and as such is classified as restricted stock, carried at cost (its redeemable value) and evaluated by management. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) the significance of the decline in net assets of the FHLB and FRB as compared to the capital stock amount and the length of time this situation has persisted, (b) commitments by the FHLB and FRB to make payments required by law or regulation and the level of such payments in relation to the operating performance, (c) the impact of legislative and regulatory changes on the customer base of the FHLB and FRB and (d) the liquidity position of the FHLB and FRB. The Company does not consider these investments to be other-than-temporarily impaired at September 30, 2016.

Securities are evaluated periodically to determine whether a decline in value is other-than-temporary. Management utilizes criteria such as the magnitude and duration of the decline, along with the reasons underlying the decline, to determine whether the loss in value is other-than-temporary. The term "other-than-temporary" is not intended to indicate that the decline in value is permanent, but indicates that the prospect for a near-term recovery of value is not necessarily favorable and that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Unrealized losses on available-for-sale investments have not been recognized into income. However, once a decline in value is determined to be other-than-temporary, the credit related other-than-temporary impairment (OTTI) is recognized in earnings while the non-credit related OTTI on securities not expected to be sold is recognized in other comprehensive income.

The following table is a summary of investment securities available-for-sale:

	(Amounts in thousands)			
	Gross		Gross	
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2016				
U.S. Government agencies and corporations	\$2,341	\$ 19	\$ —	\$2,360
Obligations of states and political subdivisions	63,620	1,771	140	65,251
U.S. Government-sponsored mortgage-backed securities	76,612	357	205	76,764
U.S. Government-sponsored collateralized mortgage obligations	6,870	33	—	6,903
U.S. Government-guaranteed small business administration pools	9,571	1	19	9,553
Trust preferred securities	1,625	—	899	726
Total debt securities	160,639	2,181	1,263	161,557
Federal Home Loan Bank (FHLB) stock	2,355	—	—	2,355
Federal Reserve Bank (FRB) stock	226	—	—	226
Total regulatory stock	2,581	—	—	2,581
Total investment securities available-for-sale	\$163,220	\$ 2,181	\$ 1,263	\$164,138

(Amounts in thousands)

		Gross	Gross	
		Unrealized	Unrealized	
December 31, 2015	Amortized	Gains	Losses	Fair
	Cost			Value
U.S. Government agencies and corporations	\$ 12,555	\$ 136	\$ 68	\$ 12,623
Obligations of states and political subdivisions	50,139	1,386	120	51,405
U.S. Government-sponsored mortgage-backed securities	70,193	165	679	69,679
U.S. Government-sponsored collateralized mortgage obligations	13,665	—	135	13,530
U.S. Government-guaranteed small business administration pools	2,883	—	46	2,837
Trust preferred securities	1,640	—	862	778
Total debt securities	151,075	1,687	1,910	150,852
Federal Home Loan Bank (FHLB) stock	2,823	—	—	2,823
Federal Reserve Bank (FRB) stock	226	—	—	226
Total regulatory stock	3,049	—	—	3,049
Total investment securities available-for-sale	\$ 154,124	\$ 1,687	\$ 1,910	\$ 153,901

Trading securities historically have been an investment in obligations of states and political subdivisions, government and agency bonds, short-term government bonds and include cash equivalent investments for trading liquidity. In the second quarter of this calendar year management decided to cease its trading activities and liquidated the investments that were in the trading account. The

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

current interest rate and economic environment mitigated the opportunities to generate revenues with a trading strategy. At September 30, 2016, the trading account was fully liquidated. At December 31, 2015, trading securities were \$8.1 million. Both realized and unrealized gains and losses are included in the Consolidated Statements of Income as shown in the following table.

	(Amounts in thousands)			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Unrealized gains	\$2	\$ 12	\$—	\$53
Unrealized losses	—	—	—	—
Net unrealized gains	2	12	—	53
Net realized (losses) gains	(2)	38	(47)	(33)
Trading securities gains (losses), net	\$—	\$ 50	\$(47)	\$20

The amortized cost and fair value of debt securities at September 30, 2016, by contractual maturity, are shown below. Actual maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	(Amounts in thousands)	
	Amortized Cost	Fair Value
Due in one year or less	\$—	\$—
Due after one year through five years	1,446	1,524
Due after five years through ten years	11,014	11,414
Due after ten years	64,697	64,952
Total	77,157	77,890
U.S. Government-sponsored mortgage-backed and related securities	83,482	83,667
Total debt securities	\$160,639	\$161,557

The table below sets forth the proceeds and gains or losses realized on available for sale securities sold or called for the periods presented:

(Amounts in thousands)

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2016	
	2015		2015	
Proceeds on securities sold	\$4,885	\$7,655	\$44,374	\$7,655
Gross realized gains	90	54	661	54
Gross realized losses	7	57	203	57

Investment securities with a carrying value of approximately \$111.3 million at September 30, 2016 and \$108.2 million at December 31, 2015 were pledged to secure deposits and for other purposes. The remaining securities provide an adequate level of liquidity.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following is a summary of the fair value of available-for-sale securities with unrealized losses and an aging of those unrealized losses at September 30, 2016:

	(Amounts in thousands)					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Obligations of states and political subdivisions	\$10,119	\$ 140	\$—	\$ —	\$10,119	\$ 140
U.S. Government-sponsored mortgage-backed securities	27,017	107	7,803	98	34,820	205
U.S. Government-guaranteed small business administration pools	6,605	19	—	—	6,605	19
Trust preferred securities	—	—	726	899	726	899
Total	\$43,741	\$ 266	\$8,529	\$ 997	\$52,270	\$ 1,263

The above table comprises 40 investment securities where the fair value is less than the related amortized cost.

The following is a summary of the fair value of available-for-sale securities with unrealized losses and an aging of those unrealized losses at December 31, 2015:

	(Amounts in thousands)					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government agencies and corporations	\$1,974	\$ 25	\$1,947	\$ 43	\$3,921	\$ 68
Obligations of states and political subdivisions	5,439	61	2,125	59	7,564	120
U.S. Government-sponsored mortgage-backed securities	35,081	315	16,575	364	51,656	679
U.S. Government-sponsored collateralized mortgage obligations	13,530	135	—	—	13,530	135
U.S. Government-guaranteed small business administration pools	2,837	46	—	—	2,837	46
Trust preferred securities	—	—	778	862	778	862
Total	\$58,861	\$ 582	\$21,425	\$ 1,328	\$80,286	\$ 1,910



The above table comprises 34 investment securities where the fair value is less than the related amortized cost.

The trust preferred securities with an unrealized loss represent pools of trust preferred debt issued primarily by bank holding companies. The unrealized losses on the Company's investment in obligations of states and political subdivisions, U.S. Government-sponsored-mortgage-backed securities and U.S. Government-guaranteed small business administration pools were caused by changes in market rates and related spreads. It is expected that the securities would not be settled at less than the amortized cost of the Company's investment because the decline in fair value is attributable to changes in interest rates and relative spreads and not credit quality. Also, except for the securities described below, the Company does not intend to sell those investments and it is not more-likely-than-not that the Company will be required to sell the investments before recovery of its amortized cost basis less any current period credit loss. The Company does not consider these investments to be other-than-temporarily impaired at September 30, 2016.

#### Securities Deemed to be Other-Than-Temporarily Impaired

The Company reviews investment debt securities on an ongoing basis for the presence of other-than-temporary impairment (OTTI) with formal reviews performed quarterly.

For debt securities in an unrealized loss position, management assesses whether (a) it has the intent to sell the debt security or (b) it is more-likely-than-not that it will be required to sell the debt security before its anticipated recovery. If either of these conditions is met, an OTTI on the security must be recognized.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

In instances in which a determination is made that a credit loss (defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis) exists but the entity does not intend to sell the debt security and it is not more-likely-than-not that the entity will be required to sell the debt security before the anticipated recovery of its remaining amortized cost basis (i.e., the amortized cost basis less any current-period credit loss), the Company presents the amount of the OTTI recognized in the Consolidated Statement of Income.

In these instances, the impairment is separated into (a) the amount of the total impairment related to the credit loss, and (b) the amount of the total impairment related to all other factors. The amount of the total OTTI related to the credit loss is recognized in earnings. The amount of the total impairment related to all other factors is recognized in other comprehensive income. The total other-than-temporary impairment is presented in the Consolidated Statement of Income with an offset for the amount of the total other-than-temporary impairment that is recognized in other comprehensive income.

As more fully disclosed in Note 9, the Company assessed the impairment of trust preferred securities currently in an illiquid market. The Company records impairment credit losses in earnings (before tax) and non-credit impairment losses in other comprehensive income (loss) (net of tax). Through the impairment assessment process, there was no OTTI loss recognized in the three and nine months ended September 30, 2016 and 2015.

The following provides a cumulative rollforward of credit losses recognized in earnings for trust preferred securities held.

	(Amounts in thousands)			
	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Beginning balance	\$ 140	\$ 140	\$ 140	\$ 140
Reduction for debt securities for which other-than-temporary impairment has been previously recognized and there is no related other comprehensive income	—	—	—	—
Credit losses on debt securities for which other-than-temporary impairment has not been previously recognized	—	—	—	—
Additional credit losses on debt securities for which other-than-temporary impairment was previously recognized	—	—	—	—
Sale of debt securities	—	—	—	—
Ending balance	\$ 140	\$ 140	\$ 140	\$ 140

At September 30, 2016 and December 31, 2015, there were \$726,000 and \$778,000, respectively, of investment securities considered to be in non-accrual status. This balance is comprised of two trust preferred securities at September 30, 2016. As a result of the delay in the collection of interest payments, management placed these securities in non-accrual status. Current estimates indicate that the interest payment delays may exceed ten years.

#### 4.) Loans and Allowance for Loan Losses:

The Company, through the Bank, grants residential, consumer and commercial loans to customers located primarily in Northeastern Ohio and Western Pennsylvania.

The following represents the composition of the loan portfolio for the period ending:

	(Amounts in thousands)			
	September 30, 2016		December 31, 2015	
	Balance	%	Balance	%
Commercial	\$61,351	15.5	\$84,613	21.5
Commercial real estate	251,149	63.5	237,137	60.1
Residential real estate	56,229	14.2	45,414	11.5
Consumer - home equity	24,095	6.1	23,334	5.9
Consumer - other	2,939	0.7	3,756	1.0
Total loans	\$395,763		\$394,254	

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, the Company has segmented loans in the portfolio by product type. Loans are segmented into the following pools: commercial loans, commercial real estate loans, residential real estate loans and consumer loans. The Company also sub-segments the consumer loan portfolio into the following two classes: home equity loans and other consumer loans. Historical loss percentages for each risk category are calculated and used as the basis for calculating allowance allocations. These historical loss percentages are calculated over multiple periods for all portfolio segments. Management evaluates these results and utilizes the most reflective period in the calculation. Certain qualitative factors are then added to the historical allocation percentage to get the adjusted factor.

These factors include, but are not limited to, the following:

Factor Considered:	Risk Trend:
Levels of and trends in charge-offs, classifications and non-accruals	Stable
Trends in volume and terms	Stable
Changes in lending policies and procedures	Stable
Experience, depth and ability of management, including loan review function	Stable
Economic trends, including valuation of underlying collateral	Stable
Concentrations of credit	Stable

The following factors are analyzed and applied to loans internally graded with higher credit risk in addition to the above factors for non-classified loans:

Factor Considered:	Risk Trend:
Levels and trends in classification	Increasing
Declining trends in financial performance	Stable
Structure and lack of performance measures	Stable
Migration between risk categories	Stable

The provision charged to operations can be allocated to a loan classification either as a positive or negative value as a result of any material changes to: net charge-offs or recovery which influence the historical allocation percentage, qualitative risk factors or loan balances.

The following is an analysis of changes in the allowance for loan losses for the periods ended:

## Three Months Ended

	(Amounts in thousands)					
	Commercial		Residential real	Consumer	Consumer	Total
September 30, 2016	Commercial	real estate	estate	- home equity	- other	
Balance at beginning of period	\$1,378	\$ 3,132	\$ 149	\$ 110	\$ 91	\$4,860
Loan charge-offs	—	(43 )	—	—	(34 )	(77 )
Recoveries	64	—	2	2	14	82

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Net loan recoveries (charge-offs)	64	(43 )	2	2	(20 )	5
Provision charged to operations	(118 )	82	76	(8 )	18	50
Balance at end of period	\$1,324	\$ 3,171	\$ 227	\$ 104	\$ 89	\$4,915

(Amounts in thousands)

September 30, 2015	Commercial	Commercial real estate	Residential real estate	Consumer - home equity	Consumer - other	Total
Balance at beginning of period	\$2,115	\$ 2,953	\$ 223	\$ 63	\$ 100	\$5,454
Loan charge-offs	(468 )	—	(40 )	—	(36 )	(544 )
Recoveries	132	—	20	4	10	166
Net loan recoveries (charge-offs)	(336 )	—	(20 )	4	(26 )	(378 )
Provision charged to operations	174	(30 )	(41 )	(12 )	9	100
Balance at end of period	\$1,953	\$ 2,923	\$ 162	\$ 55	\$ 83	\$5,176

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Nine Months Ended	(Amounts in thousands)					
	Commercial		Residential real	Consumer	Consumer	Total
September 30, 2016	Commercial	Real estate	estate	- home equity	- other	
Balance at beginning of period	\$ 1,977	\$ 2,926	\$ 153	\$ 52	\$ 86	\$5,194
Loan charge-offs	—	(287 )	—	(144 )	(117 )	(548 )
Recoveries	117	35	2	20	45	219
Net loan recoveries (charge-offs)	117	(252 )	2	(124 )	(72 )	(329 )
Provision charged to operations	(770 )	497	72	176	75	50
Balance at end of period	\$ 1,324	\$ 3,171	\$ 227	\$ 104	\$ 89	\$4,915

	(Amounts in thousands)					
	Commercial		Residential real	Consumer	Consumer	Total
September 30, 2015	Commercial	Real estate	estate	- home equity	- other	
Balance at beginning of period	\$ 2,064	\$ 2,754	\$ 229	\$ 60	\$ 95	\$5,202
Loan charge-offs	(470 )	(50 )	(45 )	—	(92 )	(657 )
Recoveries	134	10	35	13	49	241
Net loan recoveries (charge-offs)	(336 )	(40 )	(10 )	13	(43 )	(416 )
Provision charged to operations	225	209	(57 )	(18 )	31	390
Balance at end of period	\$ 1,953	\$ 2,923	\$ 162	\$ 55	\$ 83	\$5,176

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the consolidated balance sheet date.

The following tables present a full breakdown by portfolio classification of the allowance for loan losses and the recorded investment in loans at September 30, 2016 and December 31, 2015:

	(Amounts in thousands)					
	Commercial		Residential real	Consumer	Consumer	Total
September 30, 2016	Commercial	Real estate	estate	- home equity	- other	
Allowance for loan losses:						
Ending allowance balance attributable to						
loans:						
Individually evaluated for impairment	\$ —	\$ 178	\$ —	\$ —	\$ —	\$178

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Collectively evaluated for impairment	1,324	2,993	227	104	89	4,737
Total ending allowance balance	\$ 1,324	\$ 3,171	\$ 227	\$ 104	\$ 89	\$ 4,915
Loan Portfolio:						
Individually evaluated for impairment	\$ 117	\$ 6,815	\$ —	\$ —	\$ —	\$ 6,932
Collectively evaluated for impairment	61,234	244,334	56,229	24,095	2,939	388,831
Total ending loans balance	\$ 61,351	\$ 251,149	\$ 56,229	\$ 24,095	\$ 2,939	\$ 395,763

(Amounts in thousands)

	Commercial real estate		Residential real estate	Consumer - home equity	Consumer - other	Total
December 31, 2015	Commercial real estate	Commercial real estate	Residential real estate	Consumer - home equity	Consumer - other	Total
Allowance for loan losses:						
Ending allowance balance attributable to						
loans:						
Individually evaluated for impairment	\$834	\$ 178	\$ —	\$ —	\$ —	\$1,012
Collectively evaluated for impairment	1,143	2,748	153	52	86	4,182
Total ending allowance balance	\$1,977	\$ 2,926	\$ 153	\$ 52	\$ 86	\$5,194
Loan Portfolio:						
Individually evaluated for impairment	\$1,347	\$ 8,465	\$ —	\$ —	\$ —	\$9,812
Collectively evaluated for impairment	83,266	228,672	45,414	23,334	3,756	384,442
Total ending loans balance	\$84,613	\$ 237,137	\$ 45,414	\$ 23,334	\$ 3,756	\$394,254

The decrease in commercial loan balances from year-end was due in part to 90-day or less term commercial loans for a total of \$24.2 million that closed in December 2015 and were fully secured by segregated deposit accounts with the Bank. The loans matured in the first quarter of 2016. The decrease in the allowance for commercial loans is due to a reduction of specific reserves of \$834,000 due to

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

the favorable settlement of a creditor in bankruptcy, offset by the increase in the historical factor. The increase in the provision for commercial real estate loans is due mainly to an increase in the historical factor along with an increase in loan charge-offs. The increase in residential real estate provision is due to an increase in the historical factor. Along with the impact of classified loans, the amount of net charge-offs also impacts the provision charged to operations for any category of loans. Charge-offs affect the historical rate applied to each category, and the amount needed to replenish the amount charged-off, which impacted home equity and consumer loans as well as commercial real estate loans.

The following tables represent credit exposures by internally assigned grades for September 30, 2016 and December 31, 2015. The grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled or at all. The Company's internal credit risk grading system is based on experiences with similarly graded loans.

The Company's internally assigned grades are as follows:

Pass – loans which are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral. Within this category, there are grades of exceptional, quality, acceptable and pass monitor.

Special Mention – loans where a potential weakness or risk exists, which could cause a more serious problem if not corrected.

Substandard – loans that have a well-defined weakness based on objective evidence and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful – loans classified as doubtful have all the weaknesses inherent in a substandard asset but with the severity which makes collection in full highly questionable and improbable, based on existing circumstances.

Loss – loans classified as a loss are considered uncollectible, or of such value that continuance as an asset is not warranted. This rating does not mean that the assets have no recovery or salvage value but rather that the assets should be charged off now, even though partial or full recovery may be possible in the future.

The following table is a summary of credit quality indicators by internally assigned grades as of September 30, 2016 and December 31, 2015:

	(Amounts in thousands)	
	Commercial	Commercial real estate
September 30, 2016		
Pass	\$48,841	\$ 226,491
Special Mention	9,217	16,970
Substandard	3,293	7,688
Doubtful	—	—
Ending Balance	\$61,351	\$ 251,149

(Amounts in thousands)

Commercial

Commercial real estate



December 31, 2015		
Pass	\$77,095	\$ 219,958
Special Mention	4,216	7,707
Substandard	3,302	9,472
Doubtful	—	—
Ending Balance	\$84,613	\$ 237,137

The Company evaluates the classification of consumer, home equity and residential loans primarily on a pooled basis. If the Company becomes aware that adverse or distressed conditions exist that may affect a particular loan, the loan is downgraded following the above definitions of special mention and substandard. Nonaccrual loans in these categories are evaluated for charge off or charge down, and the remaining balance has the same allowance factor as pooled loans.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table is a summary of consumer credit exposure as of September 30, 2016 and December 31, 2015:

	(Amounts in thousands)		
	Residential real estate	Consumer - home equity	Consumer - other
September 30, 2016			
Performing	\$54,919	\$ 24,038	\$ 2,939
Nonperforming	1,310	57	—
Total	\$56,229	\$ 24,095	\$ 2,939

	(Amounts in thousands)		
	Residential real estate	Consumer - home equity	Consumer - other
December 31, 2015			
Performing	\$44,162	\$ 23,072	\$ 3,756
Nonperforming	1,252	262	—
Total	\$45,414	\$ 23,334	\$ 3,756

Loans are considered to be nonperforming when they become 90 days past due or on nonaccrual status, though the Company may be receiving partial payments of interest and partial repayments of principal on such loans. When a loan is placed in non-accrual status, previously accrued but unpaid interest is deducted from interest income. Loans in foreclosure are considered nonperforming.

The following table is a summary of classes of loans on non-accrual status as of September 30, 2016 and December 31, 2015:

	(Amounts in thousands)	
	September 30,	December 31,
	2016	2015
Commercial	\$—	\$ 1,196
Commercial real estate	895	2,176
Residential real estate	1,310	1,252

## Consumer:

Consumer - home equity	57	262
Consumer - other	—	—
Total	\$2,262	\$ 4,886

## Troubled Debt Restructuring

Nonperforming loans also include certain loans that have been modified in troubled debt restructurings (TDRs) where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Company's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

There were no loans modified as TDRs for the three and nine months ended September 30, 2016 and 2015. None of the loans that were approved as TDR's in 2014 or 2015 have subsequently defaulted in the twelve month periods ended September 30, 2015 and 2016.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table is an aging analysis of the recorded investment of past due loans as of September 30, 2016 and December 31, 2015:

(Amounts in thousands)							
	30-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
September 30, 2016							
Commercial	\$1	\$—	\$—	\$ 1	\$61,350	\$61,351	\$ —
Commercial real estate	992	1,470	543	3,005	248,144	251,149	—
Residential real estate	26	60	1,265	1,351	54,878	56,229	—
Consumer:							
Consumer - home equity	11	—	57	68	24,027	24,095	—
Consumer - other	9	—	—	9	2,930	2,939	—
Total	\$1,039	\$1,530	\$ 1,865	\$ 4,434	\$391,329	\$395,763	\$ —

(Amounts in thousands)							
	30-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
December 31, 2015							
Commercial	\$178	\$—	\$ 1,196	\$ 1,374	\$83,239	\$84,613	\$ —
Commercial real estate	248	1,480	2,055	3,783	233,354	237,137	—
Residential real estate	163	131	1,240	1,534	43,880	45,414	—
Consumer:							
Consumer - home equity	29	117	262	408	22,926	23,334	—
Consumer - other	10	—	—	10	3,746	3,756	—
Total	\$628	\$1,728	\$4,753	\$ 7,109	\$387,145	\$394,254	\$ —

An impaired loan is a loan on which, based on current information and events, it is probable that a creditor will be unable to collect all amounts due (including both interest and principal) according to the contractual terms of the loan agreement. However, an insignificant delay or insignificant shortfall in amount of payments on a loan does not indicate that the loan is impaired.

When a loan is determined to be impaired, impairment should be measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. However, as a practical expedient, the Company will measure impairment based on a loan's observable market price, or the fair value of the collateral if the loan is collateral dependent.

The following are the criteria for selecting individual loans / relationships for impairment analysis. Non-homogenous loans which meet the criteria below are evaluated quarterly.

All borrowers whose loans are classified doubtful by examiners and internal loan review

All loans on non-accrual status

Any loan in foreclosure

Any loan with a specific allowance

Any loan determined to be collateral dependent for repayment

Loans classified as troubled debt restructuring

Commercial loans and commercial real estate loans evaluated for impairment are excluded from the general pool of loans in the ALLL calculation regardless if a specific reserve was determined. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allowance estimate or a charge-off to the allowance.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the recorded investment and unpaid principal balances for impaired loans, excluding homogenous loans for which impaired analyses are not necessarily performed, with the associated allowance amount, if applicable, at September 30, 2016 and December 31, 2015. Also presented are the average recorded investments in the impaired balances and interest income recognized after impairment for the three and nine months ended September 30, 2016 and 2015.

	(Amounts in thousands)		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
September 30, 2016			
With no related allowance recorded:			
Commercial	\$ 117	\$ 117	\$ —
Commercial real estate	5,619	5,657	—
With an allowance recorded:			
Commercial	—	—	—
Commercial real estate	1,196	1,196	178
Total:			
Commercial	\$ 117	\$ 117	\$ —
Commercial real estate	\$6,815	\$ 6,853	\$ 178

	(Amounts in thousands)		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
December 31, 2015			
With no related allowance recorded:			
Commercial	\$ 232	\$ 264	\$ —
Commercial real estate	7,222	7,424	—
With an allowance recorded:			
Commercial	1,115	1,552	834
Commercial real estate	1,243	1,243	178
Total:			
Commercial	\$ 1,347	\$ 1,816	\$ 834
Commercial real estate	\$8,465	\$ 8,667	\$ 178

	(Amounts in thousands)	
	Three Months Ended	Nine Months Ended
	Average Interest	Average Interest
	Recorded Income	Recorded Income
	Investment Recognized	Investment Recognized

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September 30, 2016

With no related allowance recorded:

Commercial	\$ 119	\$ 4	\$ 158	\$ 9
Commercial real estate	5,634	82	6,202	244

With an allowance recorded:

Commercial	—	—	371	—
Commercial real estate	1,201	15	1,216	65

Total:

Commercial	\$ 119	\$ 4	\$ 529	\$ 9
Commercial real estate	\$ 6,835	\$ 97	\$ 7,418	\$ 309

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

	(Amounts in thousands)			
	Three Months Ended		Nine Months Ended	
	Average Interest		Average Interest	
	Recorded Income		Recorded Income	
	Investment Recognized		Investment Recognized	
September 30, 2015				
With no related allowance recorded:				
Commercial	\$ 357	\$ 4	\$ 351	\$ 10
Commercial real estate	4,533	40	4,407	124
With an allowance recorded:				
Commercial	1,168	—	1,415	—
Commercial real estate	878	20	1,123	64
Total:				
Commercial	\$ 1,525	\$ 4	\$ 1,766	\$ 10
Commercial real estate	\$ 5,411	\$ 60	\$ 5,530	\$ 188

## 5.) Legal Proceedings:

The Company is involved in legal actions arising in the ordinary course of business. In the opinion of management, the outcomes from these matters, either individually or in the aggregate, are not expected to have any material effect on the Company.

## 6.) Earnings Per Share and Capital Transactions:

Earnings per share is computed by dividing net income available to common shareholders by the weighted average number of shares of common outstanding stock, net of any treasury shares, during the period. Diluted earnings per share is calculated by dividing net income available to common shareholders by the weighted average number of shares of common stock outstanding, net of any treasury shares, after consideration of the potential dilutive effect of common stock equivalents, based upon the treasury stock method using an average market price for the period. The common stock equivalents are comprised of the restricted share awards.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net income (amounts in thousands)	\$1,195	\$1,227	\$3,730	\$3,292
Weighted average common shares outstanding	4,406,572	4,500,550	4,405,815	4,517,806
Net effect of dilutive common share equivalents	1,458	—	679	—
Adjusted average shares outstanding-dilutive	4,408,030	4,500,550	4,406,494	4,517,806



Basic earnings per share	\$0.27	\$0.27	\$0.85	\$0.73
Diluted earnings per share	\$0.27	\$0.27	\$0.85	\$0.73

#### 7.) Subordinated Debt:

In July 2007, a trust formed by the Company issued \$5.0 million of floating rate trust preferred securities as part of a pooled offering of such securities due December 2037. The Company owns all \$155,000 of the common securities issued by the trust. The securities bear interest at the 3-month LIBOR rate plus 1.45%. The rates at September 30, 2016 and December 31, 2015 were 2.30% and 1.96%, respectively. The Company issued subordinated debentures to the trust in exchange for the proceeds of the trust preferred offering. The debentures represent the sole assets of this trust. The Company may redeem the subordinated debentures, in whole or in part, at par.

The trust is not consolidated with the Company's financial statements. Accordingly, the Company does not report the securities issued by the trust as liabilities, but instead reports as liabilities the subordinated debentures issued by the Company and held by the trust. The subordinated debentures qualify as Tier 1 capital for regulatory purposes in determining and evaluating the Company's capital adequacy.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 8.) Commitments:

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, standby letters of credit and financial guarantees. Such instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the Consolidated Balance Sheets. The contract or notional amounts on those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

In the event of nonperformance by the other party, the Company's exposure to credit loss on these financial instruments is represented by the contract or notional amount of the instrument. The Company uses the same credit policies in making commitments and conditional obligations as it does for instruments recorded on the balance sheet. The amount and nature of collateral obtained, if any, is based on management's credit evaluation.

The following table is a summary of such contractual commitments:

	(Amounts in thousands)	
	September 30,	December 31,
	2016	2015
Commitments to extend credit:		
Fixed rate	\$ 26,659	\$ 13,311
Variable rate	45,753	45,929
Standby letters of credit	858	3,508

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Generally these financial arrangements have fixed expiration dates or other termination clauses and may require payment of a fee. Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment and income-producing commercial properties. The increase in commitments is in line with the Company's increased focus on commercial and industrial lending, and specifically lines of credit.

The Company also offers limited overdraft protection as a non-contractual courtesy which is available to businesses as well as individually/jointly owned accounts in good standing for personal or household use. The Company reserves the right to discontinue this service without prior notice.

The following table is a summary of overdraft protection for the periods indicated:

	(Amounts in thousands)	
	September 30,	December 31,
	2016	2015
Overdraft protection available on depositors' accounts	\$9,605	\$ 9,598
Balance of overdrafts included in loans	77	80
Average daily balance of overdrafts	101	99
Average daily balance of overdrafts as a percentage of available	1.05 %	1.03 %

Customer Derivatives - Interest Rates Swaps/Floors – The Company enters into interest rate swaps that allow our commercial loan customers to effectively convert a variable-rate commercial loan agreement to a fixed-rate commercial loan agreement. Under these agreements, the Company enters into a variable-rate loan agreement with a customer in addition to an interest rate swap agreement, which serves to effectively swap the customer's variable-rate into a fixed-rate. The Company then enters into a corresponding swap agreement with a third party in order to economically hedge its exposure through the customer agreement. The interest rate swaps with both the customers and third party are not designated as hedges under FASB ASC 815 and are marked to market through earnings. As the interest rate swaps are structured to offset each other, changes to the underlying benchmark interest rates considered in the valuation of these instruments do not result in an impact to earnings; however, there may be fair value adjustments related to credit quality variations between counterparties, which may impact earnings as required by FASB ASC 820. There was no effect on earnings in any periods presented. At September 30, 2016, the Company had one U.S. Government-sponsored mortgage-backed security pledged for collateral on its interest rate swaps with the third party financial institution with a fair value of \$1.9 million. At December 31, 2015, the Company had \$150,000 in cash pledged for collateral on its interest rate swap with the third party financial institution.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Summary information regarding these derivatives is presented below:

	(Amounts in thousands)					
	Notional Amount				Fair Value	
	September	December			September	December
	30,	31, 2015	Interest Rate Paid	Interest Rate Received	30,	31, 2015
	2016				2016	
Customer interest rate swap						
Maturing in 2020	\$2,616	\$ 2,680	1 Mo. Libor + Margin	Fixed	\$87	\$ 35
Maturing in 2025	5,714	5,921	1 Mo. Libor + Margin	Fixed	386	136
Maturing in 2026	2,206	—	1 Mo. Libor + Margin	Fixed	94	—
Total	\$10,536	\$ 8,601			\$567	\$ 171
Third party interest rate swap						
Maturing in 2020	\$2,616	\$ 2,680	Fixed	1 Mo. Libor + Margin	\$(87 )	\$ (35 )
Maturing in 2025	5,714	5,921	Fixed	1 Mo. Libor + Margin	(386)	(136 )
Maturing in 2026	2,206	—	Fixed	1 Mo. Libor + Margin	(94 )	—
Total	\$10,536	\$ 8,601			\$(567)	\$ (171 )

The following table presents the fair values of derivative instruments in the balance sheet:

(Amounts in thousands)					
Assets			Liabilities		
		Fair			Fair
September 30, 2016	Balance Sheet Location	Value	September 30, 2016	Balance Sheet Location	Value
Interest rate derivatives	Other assets	\$ 567	Interest rate derivatives	Other liabilities	\$ 567
<b>December 31, 2015</b>					
Interest rate derivatives	Other assets	\$ 171	Interest rate derivatives	Other liabilities	\$ 171

#### 9.) Fair Value of Assets and Liabilities:

##### Measurements

The Company groups assets and liabilities recorded at fair value into three levels based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. A financial

instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement (with level 1 considered highest and level 3 considered lowest). A brief description of each level follows:

Level 1: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

Level Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable

2: as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but which trade less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

Level Assets and liabilities that have little to no pricing observability as of the reported date. These items do not

3: have two-way markets and are measured using management's best estimate of fair value, where inputs into the determination of fair value require significant management judgment or estimation.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents the assets reported on the consolidated balance sheets at their fair value as of September 30, 2016 and December 31, 2015 by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

	(Amounts in thousands)			
	Fair Value Measurements at September 30, 2016 Using Quoted Prices in			
	Active Markets for			Significant
	September 30, 2016	Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Other Unobservable Inputs (Level 3)
Description	2016	1)	(Level 2)	(Level 3)
ASSETS				
U.S. Government agencies and corporations	\$2,360	\$—	\$ 2,360	\$ —
Obligations of states and political subdivisions	65,251	—	65,251	—
U.S. Government-sponsored mortgage-backed securities	76,764	—	76,764	—
U.S. Government-sponsored collateralized mortgage obligations	6,903	—	6,903	—
U.S. Government-guaranteed small business administration pools	9,553	—	9,553	—
Trust preferred securities	726	—	—	726
Regulatory stock	2,581	2,581	—	—
Loans held for sale	4,039	4,039	—	—
Interest rate derivatives	567	—	567	—
LIABILITIES				
Interest rate derivatives	\$567	\$—	\$ 567	\$ —

Description	(Amounts in thousands)			
	Fair Value Measurements at December 31, 2015 Using Quoted Prices in			
	Active Markets for			
	Significant Other		Significant	
	December 31, 2015	Identical Assets (Level 1)	Observable Inputs (Level 2)	Unobservable Inputs (Level 3)

**ASSETS**

U.S. Government agencies and corporations	\$ 12,623	\$—	\$ 12,623	\$ —
Obligations of states and political subdivisions	51,405	—	51,405	—
U.S. Government-sponsored mortgage-backed securities	69,679	—	69,679	—
U.S. Government-sponsored collateralized mortgage obligations	13,530	—	13,530	—
U.S. Government-guaranteed small business administration pools	2,837	—	2,837	—
Trust preferred securities	778	—	—	778
Regulatory stock	3,049	3,049	—	—
Trading securities	8,134	—	8,134	—
Loans held for sale	4,033	4,033	—	—
Interest rate derivatives	171	—	171	—

**LIABILITIES**

Interest rate derivatives	\$ 171	\$—	\$ 171	\$ —
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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following tables present the changes in the Level 3 fair value category for the three and nine months ended September 30, 2016 and 2015. The Company classifies financial instruments in Level 3 of the fair-value hierarchy when there is reliance on at least one significant unobservable input to the valuation model. In addition to these unobservable inputs, the valuation models for Level 3 financial instruments typically also rely on a number of inputs that are readily observable either directly or indirectly.

	(Amounts in thousands)			
	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
	Trust preferred securities	Trust preferred securities	Trust preferred securities	Trust preferred securities
Beginning balance	\$715	\$ 839	\$778	\$ 779
Net realized/unrealized losses included in:				
Noninterest income	—	—	—	—
Other comprehensive (loss) income	16	(67 )	(37 )	6
Discount accretion (premium amortization)	—	—	—	—
Sales	—	—	—	—
Purchases, issuance, and settlements	(5 )	(4 )	(15 )	(17 )
Ending balance	\$726	\$ 768	\$726	\$ 768
Losses included in net income for the period				
relating to assets held at period end	\$—	\$ —	\$—	\$ —

The Company conducts OTTI analyses on a quarterly basis. The initial indication of other-than-temporary impairment for both debt and equity securities is a decline in the fair value below the amount recorded for an investment. A decline in value that is considered to be other-than-temporary is recorded as a loss within non-interest income in the consolidated statements of income. In determining whether an impairment is other than temporary, the Company considers a number of factors, including, but not limited to, the length of time and extent to which the market value has been less than cost, recent events specific to the issuer, including investment downgrades by rating agencies and economic conditions of its industry, and a determination that the Company does not intend to sell those investments and it is not more-likely-than-not that the Company will be required to sell the investments before recovery of its amortized cost basis less any current period credit loss. Among the factors that are considered in determining the Company's intent and ability is a review of its capital adequacy, interest rate risk position and liquidity.

The Company also considers the issuer's financial condition, capital strength and near-term prospects. In addition, for debt securities the Company considers the cause of the price decline (general level of interest rates and industry- and issuer-specific factors), current ability to make future payments in a timely manner and the issuer's ability to service debt, the assessment of a security's ability to recover any decline in market value, the ability of the issuer to meet contractual obligations and the Company's intent and ability to retain the security. All of the foregoing require considerable judgment.



#### Trust Preferred Securities

Trust preferred securities are accounted for under FASB ASC Topic 325 Investments Other. The Company evaluates current available information in estimating the future cash flows of securities and determines whether there have been favorable or adverse changes in estimated cash flows from the cash flows previously projected. The Company considers the structure and term of the pool and the financial condition of the underlying issuers. Specifically, the evaluation incorporates factors such as interest rates and appropriate risk premiums, the timing and amount of interest and principal payments and the allocation of payments to the various note classes. Current estimates of cash flows are based on the most recent trustee reports, announcements of deferrals or defaults, expected future default rates and other relevant market information.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table details the breakdown of trust preferred securities for the periods indicated:

	(Dollar amounts in thousands)	
	September 30, 2016	December 31, 2015
Total number of trust preferred securities	2	2
Par value	\$1,765	\$ 1,780
Number not considered OTTI	1	1
Par value	\$765	\$ 780
Number considered OTTI	1	1
Par value	\$1,000	\$ 1,000
Life-to-date impairment recognized in earnings	\$140	\$ 140
Life-to-date impairment recognized in other comprehensive income	899	862
Total life-to-date impairment	\$1,039	\$ 1,002

The following table details the one debt security with other-than-temporary impairment, its credit rating at September 30, 2016 and the related losses recognized in earnings:

		(Amounts in thousands)				
		Amount of OTTI related to credit loss at		Amount of OTTI related to credit loss at		
		Additions in QTD		Additions in QTD		
		January 31, 2016	March 31, 2016	June 30, 2016	September 30, 2016	September 30, 2016
	Moody's/Fitch 1, Rating	2016	2016	2016	2016	2016
Trapeza IX B-1	Caa2/CC	\$140	\$ —	\$ —	\$ —	\$ 140
Total		\$140	\$ —	\$ —	\$ —	\$ 140

The following table details the one debt security with other-than-temporary impairment, its credit ratings at September 30, 2015 and the related losses recognized in earnings:

(Amounts in thousands)						
Amount of					Amount of	
OTTI					OTTI	
related to					OTTI	
credit loss					credit loss	
at					at	
Additions in QTD					Additions in QTD	
Additions in QTD					Additions in QTD	
September 30,					September 30,	
Moody's/Fitch 1,					Moody's/Fitch 1,	
Rating					Rating	
2015					2015	
2015					2015	
2015					2015	
2015					2015	
2015					2015	
Trapeza IX B-1	Caa2/CC	\$ 140	\$ —	\$ —	\$ —	\$ 140
Total		\$ 140	\$ —	\$ —	\$ —	\$ 140

The following table provides additional information related to the Company's trust preferred securities as of September 30, 2016 used to evaluate other-than-temporary impairments:

(Amounts in thousands)									
					Deferrals and		Excess		
					Number of		Subordination		
					Defaults		as a		
					as a %		% of Current		
					of		Performing		
					Current				
					Collateral				
Deal	Class	Amortized Cost	Fair Value	Unrealized Gain/(Loss)	Moody's/ Fitch Rating	Number of Currently Performing	Deferrals and Defaults as a % of Current	Excess Subordination as a % of Current	Collateral
PreTSL XXIII	C-2	\$ 765	\$ 273	\$ (492 )	B2/CCC	91	22.5 %	5.28 %	
Trapeza IX	B-1	860	453	(407 )	Caa2/CC	32	13.3	1.05	
Total		\$ 1,625	\$ 726	\$ (899 )					

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table provides additional information related to the Company's trust preferred securities as of December 31, 2015 used to evaluate other-than-temporary impairments:

(Amounts in thousands)

						Number of	Deferrals and	Excess
						Issuers	Defaults as a %	Subordination as a
						Currently	of Current	% of Current
								Performing
Amortized								
Deal	Class	Cost	Fair Value	Gain/(Loss)	Fitch Rating	Performing	Collateral	Collateral
PreTSL XXIII	C-2	\$ 780	\$ 332	\$ (448 )	B2/CCC	90	22.5 %	1.77 %
Trapeza IX	B-1	860	446	(414 )	Caa2/CC	31	18.5	—
Total		\$ 1,640	\$ 778	\$ (862 )				

The market for these securities at September 30, 2016 and December 31, 2015 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which trust preferred securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive as new issuance is essentially nonexistent. There are currently very few market participants who are willing and/or able to transact for these securities. The pooled market value for these securities remains very depressed relative to historical levels. Although there has been marked improvement in the credit spread premium in the corporate bond space, no such improvement has been noted in the market for trust preferred securities.

Given conditions in the debt markets today and the absence of observable transactions in the secondary and the new issue markets, the Company determined the following:

The few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at September 30, 2016;

An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at measurement dates prior to 2008; and

The trust preferred securities will be classified within Level 3 of the fair value hierarchy because the Company determined that significant judgments are required to determine fair value at the measurement date.

The Company enlisted the aid of an independent third party to perform the trust preferred security valuations. The approach to determining fair value involved the following process:

1. Estimate the credit quality of the collateral using average probability of default values for each issuer (adjusted for rating levels).
2. Consider the potential for correlation among issuers within the same industry for default probabilities (e.g. banks with other banks).

3. Forecast the cash flows for the underlying collateral and apply to each trust preferred security tranche to determine the resulting distribution among the securities, including prepayment and cures.
4. Discount the expected cash flows to calculate the present value of the security.

The PreTSL XXIII cash flows are discounted at 15.30% through its maturity date of December 2036 and would have to experience an additional \$220 million of nonperforming collateral (of \$857 million performing) in order to incur any impairment. The aggregate cash flows for the C-2 tranche are estimated to be \$39.8 million on a current principal of \$26.3 million. The Trapeza IX cash flows are discounted at 9.00% through its maturity of January 2038 and would experience additional impairment upon further occurrence of nonperforming collateral of \$20 million (of \$213 million performing). The aggregate cash flows for the B-1 tranche are estimated to be \$38.4 million on a current principal of \$23.7 million.

The following table presents the assets measured on a nonrecurring basis on the Consolidated Balance Sheets at their fair value as of September 30, 2016 and December 31, 2015, by level within the fair value hierarchy. Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secure the impaired loans include: quoted market prices for identical assets classified as Level 1 inputs; observable inputs, employed by certified appraisers, for similar assets classified as Level 2 inputs. In cases where valuation techniques include inputs that are unobservable and are based on estimates and assumptions developed by management based on the best information available under each circumstance,

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

the asset valuation is classified as Level 3 inputs. Other real estate owned is carried at the lower of cost or fair value less estimated costs to sell.

(Amounts in thousands)				
September 30, 2016				
	Level 1	Level 2	Level 3	Total
Assets measured on a nonrecurring basis:				
Impaired loans	\$—	\$—	\$6,754	\$6,754
Other real estate owned	—	—	57	57

(Amounts in thousands)				
December 31, 2015				
	Level 1	Level 2	Level 3	Total
Assets measured on a nonrecurring basis:				
Impaired loans	\$—	\$—	\$8,800	\$8,800
Other real estate owned	—	—	61	61

## Financial Instruments

The Company discloses fair value information about financial instruments, whether or not recognized in the consolidated balance sheets, for which it is practicable to estimate the value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other estimation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows.

Such techniques and assumptions, as they apply to individual categories of the financial instruments, are as follows:

**Cash and cash equivalents** – The carrying amounts for cash and cash equivalents are a reasonable estimate of those assets' fair value.

**Investment securities** – Fair values of securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable securities. Prices on trust preferred securities were calculated using a discounted cash-flow technique. Cash flows were estimated based on credit and prepayment assumptions. The present value of the projected cash flows was calculated using a discount rate equal to the current yield used to accrete the beneficial interest.

**Loans held for sale** – Loans held for sale consist of residential mortgage loans originated for sale. Loans held for sale are recorded at fair value based on what the secondary markets have offered on best efforts commitments.

Loans, net of allowance for loan losses – Market quotations are generally not available for loan portfolios. The fair value is estimated by discounting future cash flows using current market inputs at which loans with similar terms and qualities would be made to borrowers of similar credit quality.

Bank-owned life insurance – The fair value is based upon the cash surrender value of the underlying policies net of any split dollar obligation and matches the book value.

Accrued interest receivable – The carrying amount is a reasonable estimate of these assets' fair value.

Interest rate derivatives – The fair value is based on settlement values adjusted for credit risks associated with the counter parties and the Company and observable market interest rate curves.

Demand, savings and money market deposits – Demand, savings, and money market deposit accounts are valued at the amount payable on demand.

Time deposits – The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The discount rates are estimated using market rates currently offered for similar instruments with similar remaining maturities.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Short term borrowings – Short term borrowings generally have an original term to maturity of one year or less. Consequently, their carrying value is a reasonable estimate of fair value.

FHLB advances - short term – Short term borrowings generally have an original term to maturity of one year or less. Advances of one month or less are considered to be at fair value. The fair value of notes with one to twelve month terms is based on the discounted value of contractual cash flows. The discount rates are estimated using market rates currently offered for similar instruments with similar remaining maturities.

FHLB advances - long term – The fair value for fixed rate advances is estimated by discounting the future cash flows using rates at which advances would be made to borrowers with similar credit ratings and for the same remaining maturities. The fair value for the fixed rate advances that are convertible to quarterly LIBOR floating rate advances on or after certain specified dates at the option of the FHLB and the FHLB fixed rate advances that are puttable on or after certain specified dates at the option of the FHLB are priced using the FHLB of Cincinnati's model.

Subordinated debt – The floating issuances curves to maturity are averaged to obtain an index. The spread between BBB-rated bank debt and 25-year swap rates is determined to calculate the spread on outstanding trust preferred securities. The discount margin is then added to the index to arrive at a discount rate, which determines the present value of projected cash flows.

Accrued interest payable – The carrying amount is a reasonable estimate of these liabilities' fair value. The fair value of unrecorded commitments at September 30, 2016 and December 31, 2015 is not material.

In addition, other assets and liabilities of the Company that are not defined as financial instruments are not included in the disclosures, such as property and equipment. Also, non-financial instruments typically not recognized in financial statements nevertheless may have value but are not included in the above disclosures. These include, among other items, the estimated earning power of core deposit accounts, the trained work force, customer goodwill and similar items. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The carrying amounts and fair values of the Company's financial instruments are as follows:

(Amounts in thousands)					
September 30, 2016					
Carrying					
	Amount	Level 1	Level 2	Level 3	Fair Value
<b>ASSETS:</b>					
Cash and cash equivalents	\$22,287	\$22,287	\$—	\$—	\$22,287
Investment securities available-for-sale	164,138	2,581	160,831	726	164,138
Loans held for sale	4,039	4,039	—	—	4,039
Loans, net of allowance for loan losses	390,848	—	—	394,898	394,898
Bank-owned life insurance	17,301	17,301	—	—	17,301
Accrued interest receivable	1,989	1,989	—	—	1,989
Interest rate derivatives	567	—	567	—	567



**LIABILITIES:**

Demand, savings and money market deposits	\$372,030	\$372,030	\$—	\$—	\$372,030
Time deposits	136,422	—	—	138,937	138,937
Short term borrowings	2,313	2,313	—	—	2,313
Federal Home Loan Bank advances - short term	14,000	8,000	—	6,000	14,000
Federal Home Loan Bank advances - long term	20,500	—	—	20,706	20,706
Subordinated debt	5,155	—	—	4,249	4,249
Accrued interest payable	294	294	—	—	294
Interest rate derivatives	567	—	567	—	567

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

(Amounts in thousands)

December 31, 2015

	Carrying				Fair
	Amount	Level 1	Level 2	Level 3	Value
<b>ASSETS:</b>					
Cash and cash equivalents	\$18,496	\$18,496	\$—	\$—	\$18,496
Investment securities available-for-sale	153,901	3,049	150,074	778	153,901
Trading securities	8,134	—	8,134	—	8,134
Loans held for sale	4,033	4,033	—	—	4,033
Loans, net of allowance for loan losses	389,060	—	—	393,355	393,355
Bank-owned life insurance	17,328	17,328	—	—	17,328
Accrued interest receivable	1,640	1,640	—	—	1,640
Interest rate derivatives	171	—	171	—	171
<b>LIABILITIES:</b>					
Demand, savings and money market deposits	\$364,577	\$364,577	\$—	\$—	\$364,577
Time deposits	131,827	—	—	134,251	134,251
Short term borrowings	2,499	2,499	—	—	2,499
Federal Home Loan Bank advances - short term	17,000	12,000	—	4,995	16,995
Federal Home Loan Bank advances - long term	25,000	—	—	25,667	25,667
Subordinated debt	5,155	—	—	4,321	4,321
Accrued interest payable	255	255	—	—	255
Interest rate derivatives	171	—	171	—	171

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents quantitative information about the Level 3 significant unobservable inputs for assets and liabilities measured at fair value on a recurring and nonrecurring basis at September 30, 2016:

	(Amounts in thousands) Fair value at			
	September 30,	Valuation	Significant	Description of
	2016	Technique	Unobservable Input	Inputs
Trust preferred securities \$ 726		Discounted Cash Flow	Projected  Prepayments	1) Trust preferred securities issued by banks subject to Dodd-Frank's phase-out of trust preferred securities from Tier 1 Capital. All fixed rate within one year; variable rate at increasing intervals depending on spread.  2) Trust preferred securities issued by healthy, well capitalized banks that have fixed rate coupons greater than 8%.

	3) 1% annually for all other fixed rate issues and all variable rate issues.
	4) Zero for collateral issued by REITs and 2% for insurance companies.
Projected Defaults	<p>1) All deferring issuers that do not meet the criteria for curing, as described below, are projected to default immediately.</p> <p>2) Banks with high, near term default risk are identified using a CAMELS model, and projected to default immediately. Healthy banks are projected to default at a rate of 2% annually for 2 years, and 0.36% annually thereafter.</p> <p>3) Insurance and REIT defaults are</p>

projected according to the historical default rates exhibited by companies with the same credit ratings. Historical default rates are doubled in each of the first two years of the projection to account for current economic conditions. Unrated issuers are assumed to have CCC-ratings.

Projected Cures 1) Deferring issuers that have definitive agreements to either be acquired or recapitalized.

Projected Recoveries 1) Zero for insurance companies, REITs and insolvent banks, and 10% for projected bank deferrals lagged 2 years.

Discount Rates 1) Ranging from ~9.00% to ~15.30%, depending on each bond's

				seniority and remaining subordination after projected losses.
Impaired loans	6,754			Range (0)% to (50)%
		Appraisal of Collateral (1)	Appraisal Adjustments (2)	Weighted average (29)%
			Liquidation Expenses (2)	Range (0)% to (48)% Weighted average (5)%
Other real estate owned	57	Appraisal of Collateral (1), (3)	Appraisal Adjustments (2)	0%

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.

(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses are presented as a percent of the appraisal. The adjustment of appraised value is measured as the effect on fair value as a percentage of unpaid principal.

(3) Includes qualitative adjustments by management and estimated liquidation expenses.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The following table presents quantitative information about the Level 3 significant unobservable inputs for assets and liabilities measured at fair value on a recurring and nonrecurring basis at December 31, 2015:

(Amounts in thousands) Fair value at				
	December 31, 2015	Valuation Technique	Significant Unobservable Input	Description of Inputs
Trust preferred securities	\$ 778	Discounted Cash Flow	Projected Prepayments	1) Trust preferred securities issued by banks subject to Dodd-Frank's phase-out of trust preferred securities from Tier 1 Capital. All fixed rate within one year; variable rate at increasing intervals depending on spread.
				2) Trust preferred securities issued by healthy, well capitalized banks that have fixed rate coupons greater than 8%.
				3) 1% annually for all other fixed rate issues and all variable rate issues.
				4) Zero for collateral issued by REITs and 2% for insurance companies.
			Projected Defaults	1) All deferring issuers that do not meet the criteria for curing, as described below, are projected to default immediately.
				2) Banks with high, near term default risk are identified using a CAMELS model, and projected to default immediately. Healthy banks are projected to default at a rate of 2% annually for 2 years, and 0.36% annually thereafter.
				3) Insurance and REIT defaults are projected according to the historical default rates exhibited by companies with the same credit ratings. Historical default rates are doubled in each of the first two years of the projection to account for current economic conditions. Unrated issuers are assumed to have CCC- ratings.

Projected Cures

1) Deferring issuers that have definitive agreements to either be acquired or recapitalized.

Projected

Recoveries

1) Zero for insurance companies, REITs and insolvent banks, and 10% for projected bank deferrals lagged 2 years.

Discount Rates

1) Ranging from ~10.26% to ~14.12%, depending on each bond's seniority and remaining subordination after projected losses.

Impaired  
loans

8,800

Appraisal of

Appraisal

Range (0)% to (53)%

Collateral

(1)

Adjustments (2)

Weighted average (29)%

Liquidation

Range (0)% to (43)%

Expenses (2)

Weighted average (5)%

Other real  
estate  
owned

61

Appraisal of

Appraisal

Collateral

(1), (3)

Adjustments (2) 0%

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.

(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses are presented as a percent of the appraisal. The adjustment of appraised value is measured as the effect on fair value as a percentage of unpaid principal.

(3) Includes qualitative adjustments by management and estimated liquidation expenses.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 10.) Accumulated Other Comprehensive Income (Loss):

The following table presents the changes in accumulated other comprehensive income (loss) by component net of tax for the three and nine months ended September 30, 2016 and 2015:

	(Amounts in thousands)							
	Three Months Ended		2015		Nine Months Ended		2015	
	September 30,				September 30,			
	2016		2015		2016		2015	
	Unrealized	Change in	Unrealized	Change in	Unrealized	Change in	Unrealized	Change in
	gains (losses)	pension	gains (losses)	pension	gains (losses)	pension	gains (losses)	pension
	on	and	on	and	on	and	on	and
	available-for-sale securities	postretirement obligations	available-for-sale securities	postretirement obligations	available-for-sale securities	postretirement obligations	available-for-sale securities	postretirement obligations
Beginning balance	\$1,214	\$ (66 )	\$ (359 )	\$ (29 )	\$ (147 )	\$ (91 )	\$ 360	\$ 16
Other comprehensive income (loss)								
before reclassification	(553 )	12	639	(23 )	1,055	37	(80 )	(68 )
Amount reclassified from accumulated other comprehensive income (loss)	(55 )	—	2	—	(302 )	—	2	—
Total other comprehensive income (loss)	(608 )	12	641	(23 )	753	37	(78 )	(68 )
Ending balance	\$606	\$ (54 )	\$ 282	\$ (52 )	\$ 606	\$ (54 )	\$ 282	\$ (52 )

The following table presents significant amounts reclassified out of each component of accumulated other comprehensive income for the three and nine months ended September 30, 2016 and 2015:

(Amounts in thousands)					
Three Months Ended		Nine Months Ended			
September 30,		September 30,			
2016	2015	2016	2015		
Amount reclassified	Amount reclassified	Amount reclassified	Amount reclassified	Affected line item in the statement where net income is presented	

from accumulated other comprehensive income	from accumulated other comprehensive income	from accumulated other comprehensive income	from accumulated other comprehensive income
---	---	---	---

Details about other  
comprehensive

income or loss:

Unrealized gains (losses)  
on

available-for-sale securities	\$ (83 ) \$ 3	\$ (458 ) \$ 3	Investment securities available-for-sale gains (losses), net
	28 (1 )	156 (1 )	Federal income tax expense
	\$ (55 ) \$ 2	\$ (302 ) \$ 2	Net of tax

# 11.) Post-Retirement Obligations:

The Company accrues for the monthly benefit expense of post-retirement cost of insurance for split dollar life insurance coverage. The following table presents the changes in the accumulated liability:

	(Amounts in thousands)			
	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
Beginning balance	\$842	\$752	\$856	\$616
Expense recorded	6	13	17	104
Other comprehensive income (loss) recorded	(12 )	23	(37 )	68
Ending balance	\$836	\$788	\$836	\$788

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

## 12.) Stock Repurchase Program:

On March 24, 2015, the Company's Board of Directors adopted a Stock Repurchase Program which allowed the Company to repurchase up to 200,000 shares or approximately 4.4% of its 4,527,849 outstanding common shares in the open market or in privately negotiated transactions in accordance with applicable regulations of the Securities and Exchange Commission. Based on the value of the Company's stock on March 24, 2015, the commitment to repurchase the stock during the program was approximately \$3.1 million. The repurchase program terminated on December 31, 2015. As of December 31, 2015, the Company had repurchased 123,066 shares under the program. Repurchased shares are designated as treasury shares, available for general corporate purposes, including possible use in connection with the Company's dividend reinvestment program, employee benefit plans, acquisitions or other distributions. On January 26, 2016, the Company's Board of Directors approved a new program which allows the Company to repurchase up to 100,000 shares, or approximately 2.3% of the 4,404,783 shares outstanding at January 26, 2016, of the Company's outstanding common stock. This program will terminate on December 31, 2016 or upon purchase of 100,000 shares if earlier or at any time without prior notice. The Company has not purchased any shares under this program to date. Based on the value of the Company's stock on September 30, 2016, the commitment to repurchase the stock over the program is approximately \$1.6 million.

## 13.) Short-Term Borrowings:

The following table provides additional detail regarding short-term borrowings:

	(Amounts in thousands)	
	Repurchase Agreements (Sweep)	
	Accounted for as Secured Borrowings	
	At September 30, 2016	
	At December 31, 2015	
	Remaining Contractual Maturity of the Agreements	
	Overnight and Continuous	
	Overnight and Continuous	
Repurchase agreements:		
U.S. Government-sponsored mortgage-backed securities	\$3,069	\$ 4,729
U.S. Government-sponsored collateralized mortgage obligations	—	1,088
Total collateral carrying value	\$3,069	\$ 5,817

Total short-term borrowings	\$2,313	\$ 2,499
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#### 14.) Equity Compensation:

During 2015, the Company, created the 2015 Omnibus Equity Plan and The Director Equity Plan.

The Omnibus Equity Plan permits the award of up to 340,000 shares to the Company's employees to promote the long-term financial success of the Company, increasing stockholder value by providing employees the opportunity to acquire an ownership interest in the Company and enabling the Company and its related entities to attract and retain the services of those upon whom the successful conduct of business depends. There were 13,683 restricted board approved shares granted under the plan in April 2016. The Company is expensing the grant date fair value of all share-based compensation over the requisite vesting periods on a prorated straight-line basis. In 2016, \$30,000 was recorded in the Consolidated Statement of Income. As of September 30, 2016, there was \$179,000 of total unrecognized compensation expense related to the non-vested shares granted under the Plan. Shares awarded under this plan vest in equal thirds on the first three anniversaries of the award date if the employee remains employed with Cortland Bancorp. The remaining cost is expected to be recognized over 2.5 years, which is the remainder of the three-year tiered vesting period. There were no shares granted under the plan in 2015.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Granted shares are awarded upon meeting achievement of performance objectives derived from one or more of the performance criteria. The main metrics used include net earnings, earnings per share, return on average assets and equity, share price and other earnings ratios.

The Director Equity Plan permits the award of up to 113,000 shares to nonemployee directors to promote the long-term financial success of the Company, increasing stockholder value by enabling the Company and its related entities to attract and retain the services of those directors upon whom the successful conduct of business depends. There were 1,789 board approved shares granted under the plan in April 2016 with immediate vesting. In 2016, \$27,000 was recorded in the Consolidated Statement of Income.

The following is the activity under the two plans during the nine months ended September 30, 2016:

	Restricted Stock	
	Units	Price
	Units	at Grant Date
Nonvested at January 1, 2016	—	\$—
Granted	15,472	15.25
Vested	1,789	15.25
Forfeited	—	—
Nonvested at September 30, 2016	13,683	\$15.25

## CONSOLIDATED AVERAGE BALANCE SHEETS, YIELDS AND RATES (UNAUDITED)

(Fully taxable equivalent basis in thousands of dollars)

YEAR-TO-DATE AS OF

	SEPTEMBER 30, 2016			DECEMBER 31, 2015			SEPTEMBER 30, 2015		
	Average	Average		Average	Average		Average	Average	
	Balance	Interest	Rate	Balance	Interest	Rate	Balance	Interest	Rate
<b>ASSETS</b>									
Interest earning deposits	\$8,010	\$33	0.55 %	\$5,930	\$19	0.32 %	\$5,675	\$13	0.31 %
Investment securities available for sale and trading (1) (2) (3)	162,845	3,625	2.98 %	166,155	5,043	3.04 %	167,177	3,809	3.04 %
Loans (1) (2) (3)	388,192	13,824	4.75 %	358,609	16,933	4.72 %	354,248	12,566	4.74 %
Total interest-earning assets	559,047	\$17,482	4.17 %	530,694	\$21,995	4.14 %	527,100	\$16,388	4.15 %
Cash and due from banks	7,822			7,399			7,244		
Bank premises and equipment	9,022			7,165			6,566		
Other assets	26,548			23,639			23,229		
Total noninterest-earning assets	43,392			38,203			37,039		
Total assets	\$602,439			\$568,897			\$564,139		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>									
Interest-bearing demand deposits	\$133,299	\$303	0.30 %	\$110,130	\$269	0.24 %	\$107,003	\$188	0.24 %
Savings	113,402	58	0.07 %	113,272	66	0.06 %	113,567	49	0.07 %
Time	134,706	1,176	1.16 %	133,490	1,333	1.01 %	133,371	989	1.00 %
Total interest-bearing deposits	381,407	1,537	0.54 %	356,892	1,668	0.47 %	353,941	1,226	0.47 %
Other borrowings	36,057	536	1.98 %	43,761	848	1.94 %	45,213	635	1.88 %
Subordinated debt	5,155	81	2.07 %	5,155	91	1.75 %	5,155	67	1.72 %
Total interest-bearing liabilities	422,619	\$2,154	0.68 %	405,808	\$2,607	0.64 %	404,309	\$1,928	0.64 %
Demand deposits	110,319			98,028			95,541		
Other liabilities	10,713			8,436			7,819		

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Shareholders' equity	58,788	56,625	56,470
Total liabilities and			
shareholders' equity	\$602,439	\$568,897	\$564,139
Net interest income	\$15,328	\$19,388	\$14,460
Net interest rate spread			
(4)	3.49 %	3.50 %	3.51 %
Net interest margin (5)	3.66 %	3.65 %	3.66 %
Ratio of			
interest-earning assets			
to interest-bearing			
liabilities	1.32	1.31	1.30

- (1) Includes both taxable and tax exempt loans and investment securities available-for-sale and trading.
- (2) The amounts are presented on a fully taxable equivalent basis using the statutory rate of 34%, and have been adjusted to reflect the effect of disallowed interest expenses related to carrying tax-exempt assets. The tax equivalent income adjustment for loans and investments available-for-sale and trading was \$13,000 and \$676,000, respectively, for September 30, 2016; \$24,000 and \$858,000, respectively, for December 31, 2015; and \$19,000 and \$651,000, respectively, for September 30, 2015.
- (3) Average balance outstanding includes the average amount outstanding of all non-accrual investment securities and loans. Investment securities consist of average total principal adjusted for amortization of premium and accretion of discount and includes both taxable and tax-exempt securities. Loans consist of average total loans, including loans held for sale, less average deferred fees and costs.
- (4) Interest rate spread represents the difference between the yield on earning assets and the rate paid on interest-bearing liabilities.
- (5) Interest margin is calculated by dividing net interest income by total interest-earning assets.

## CONSOLIDATED AVERAGE BALANCE SHEETS, YIELDS AND RATES (UNAUDITED)

(Fully taxable equivalent basis in thousands of dollars)

QUARTER-TO-DATE AS OF

	SEPTEMBER 30, 2016			JUNE 30, 2016			SEPTEMBER 30, 2015		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
<b>ASSETS</b>									
Interest earning deposits	\$7,938	\$11	0.56 %	\$8,127	\$10	0.52 %	\$5,145	\$4	0.31 %
Investment securities available for sale and trading (1) (2)									
(3)	163,467	1,170	2.88 %	167,255	1,247	2.96 %	162,426	1,226	3.03 %
Loans (1) (2) (3)	396,116	4,709	4.74 %	383,536	4,724	4.93 %	362,664	4,287	4.71 %
Total interest-earning assets	567,521	\$5,890	4.14 %	558,918	\$5,981	4.28 %	530,235	\$5,517	4.15 %
Cash and due from banks	7,990			7,720			7,472		
Bank premises and equipment	8,917			9,014			6,819		
Other assets	27,037			27,097			24,898		
Total non-interest-earning assets	43,944			43,831			39,189		
Total assets	\$611,465			\$602,749			\$569,424		
<b>LIABILITIES AND</b>									
<b>SHAREHOLDERS'</b>									
<b>EQUITY</b>									
Interest-bearing demand deposits	\$138,292	\$112	0.32 %	\$132,117	\$100	0.30 %	\$109,249	\$69	0.25 %
Savings	112,082	20	0.07 %	113,818	19	0.07 %	112,859	17	0.06 %
Time	134,436	403	1.18 %	135,151	397	1.18 %	130,818	326	0.99 %
Total interest-bearing deposits	384,810	535	0.55 %	381,086	516	0.54 %	352,926	412	0.46 %
Other borrowings	37,667	180	1.89 %	36,188	176	1.95 %	45,765	214	1.85 %
Subordinated debt	5,155	28	2.13 %	5,155	27	2.09 %	5,155	23	1.74 %
Total interest-bearing liabilities	427,632	\$743	0.69 %	422,429	\$719	0.68 %	403,846	\$649	0.64 %
Demand deposits	112,755			111,346			100,262		
Other liabilities	11,045			10,096			8,700		
Shareholders' equity	60,033			58,878			56,616		
Total liabilities and shareholders' equity	\$611,465			\$602,749			\$569,424		
Net interest income		\$5,147			\$5,262			\$4,868	
Net interest rate spread (4)			3.45 %			3.60 %			3.51 %
Net interest margin (5)			3.63 %			3.77 %			3.67 %



Ratio of interest-earning  
assets to

interest-bearing liabilities	1.33	1.32	1.31
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- (1) Includes both taxable and tax exempt loans and investment securities available-for-sale and trading.
- (2) The amounts are presented on a fully taxable equivalent basis using the statutory rate of 34%, and have been adjusted to reflect the effect of disallowed interest expenses related to carrying tax-exempt assets. The tax equivalent income adjustment for loans and investments available-for-sale and trading was \$4,000 and \$226,000, respectively, for September 30, 2016; \$4,000 and \$237,000, respectively, for June 30, 2016; and \$5,000 and \$217,000, respectively, for September 30, 2015.
- (3) Average balance outstanding includes the average amount outstanding of all non-accrual investment securities and loans. Investment securities consist of average total principal adjusted for amortization of premium and accretion of discount and includes both taxable and tax-exempt securities. Loans consist of average total loans, including loans held for sale, less average deferred fees and costs.
- (4) Interest rate spread represents the difference between the yield on earning assets and the rate paid on interest-bearing liabilities.
- (5) Interest margin is calculated by dividing net interest income by total interest-earning assets.

## SELECTED FINANCIAL DATA FOR THE QUARTER ENDED

(In thousands of dollars, except for ratios and per share amounts)

Unaudited	September 30, 2016	June 30, 2016	March 31, 2016	December 31, 2015	September 30, 2015
<b>SUMMARY OF OPERATIONS</b>					
Total interest income	\$ 5,660	\$ 5,740	\$ 5,393	\$ 5,395	\$ 5,295
Total interest expense	(743 )	(719 )	(692 )	(679 )	(649 )
NET INTEREST INCOME (NII)	4,917	5,021	4,701	4,716	4,646
Provision for loan losses	(50 )	—	—	(65 )	(100 )
NII after loss provision	4,867	5,021	4,701	4,651	4,546
Investment securities gains	83	4	324	47	47
Mortgage banking gains	341	465	349	149	291
Other income	696	696	734	754	708
Total non-interest expense	(4,479 )	(4,734 )	(4,484 )	(4,192 )	(3,990 )
Income before tax expense	1,508	1,452	1,624	1,409	1,602
Federal income tax expense	313	279	262	323	375
Net income	\$ 1,195	\$ 1,173	\$ 1,362	\$ 1,086	\$ 1,227

**PER COMMON SHARE DATA (1)**

Earnings per share, basic and diluted	\$ 0.27	\$ 0.27	\$ 0.31	\$ 0.24	\$ 0.27
Book value	13.65	13.67	13.23	12.87	12.82
Dividends per share	0.07	0.07	0.07	0.06	0.06

**BALANCE SHEET DATA**

Assets	\$ 621,162	\$ 606,361	\$ 590,393	\$ 612,443	\$ 570,250
Investments	164,138	163,796	166,043	162,035	159,809
Loans	391,553	384,058	373,788	394,254	359,834
Allowance for loan losses	4,915	4,860	5,180	5,194	5,176
Deposits	508,452	488,675	481,941	496,404	454,547
Borrowings	41,968	41,942	41,263	49,654	49,874
Shareholders' equity	60,334	60,223	58,270	56,684	57,235

**AVERAGE BALANCES**

Assets	\$ 611,465	\$ 602,749	\$ 593,006	\$ 583,014	\$ 569,424
Investments	163,467	167,255	157,807	163,122	162,426
Loans	391,553	379,274	381,224	367,812	359,662
Deposits	497,565	492,432	485,115	471,054	453,188
Borrowings	42,822	41,343	39,456	44,611	50,920
Shareholders' equity	60,033	58,878	57,438	57,089	56,616

**ASSET QUALITY RATIOS**

Net recoveries (charge-offs)	\$ 5	\$ (320 )	\$ (14 )	\$ (47 )	\$ (378 )
Net recoveries (charge-offs) as a percentage	0.01 %	(0.34 )%	(0.01 )%	(0.05 )%	(0.42 )%

of average total loans										
Loans 30 days or more beyond their contractual due										
date as a percent of total loans	1.12	%	1.12	%	1.63	%	1.80	%	1.85	%
Nonperforming loans	\$ 8,299		\$ 8,545		\$ 11,306		\$ 11,542		\$ 8,442	
Nonperforming securities	726		715		725		778		768	
Other real estate owned	57		58		60		61		62	
Total nonperforming assets	\$ 9,082		\$ 9,318		\$ 12,091		\$ 12,381		\$ 9,272	
Nonperforming assets as a percentage of:										
Total assets	1.46	%	1.54	%	2.05	%	2.02	%	1.63	%
Equity plus allowance for loan losses	13.92		14.32		19.06		20.01		14.86	
Tier I capital	14.02		14.54		19.20		19.99		14.95	
FINANCIAL RATIOS										
Return on average equity	7.96	%	7.97	%	9.49	%	7.61	%	8.67	%
Return on average assets	0.78		0.78		0.92		0.75		0.86	
Efficiency ratio	72.42		73.84		71.13		72.28		67.42	
Effective tax rate	20.76		19.21		16.13		22.92		23.41	
Net interest margin	3.63		3.77		3.58		3.63		3.67	

(1) Earnings per share are based on weighted average shares outstanding. Book value per common share is based on shares outstanding at each period.

## ITEM 2. MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Financial Review

The following is management’s discussion and analysis of the financial condition and results of operations of Cortland Bancorp (the Company). The discussion should be read in conjunction with the Consolidated Financial Statements and related notes and summary financial information included elsewhere in this quarterly report.

### Note Regarding Forward-looking Statements

The Private Securities Litigation Reform Act of 1995 provides a “safe harbor” for forward-looking statements. In addition to historical information, certain information included in this discussion and other material filed or to be filed by the Company with the Securities and Exchange Commission (as well as information included in oral statements or other written statements made or to be made by the Company) may contain forward-looking statements that involve risks and uncertainties. The words “believes,” “expects,” “may,” “will,” “should,” “projects,” “contemplates,” “anticipates,” “f” “intends,” or similar terminology identify forward-looking statements. These statements reflect management’s beliefs and assumptions, and are based on information currently available to management.

Economic circumstances, the Company’s operations and actual results could differ significantly from those discussed in any forward-looking statements. Some of the factors that could cause or contribute to such differences are changes in the economy and interest rates either nationally or in the Company’s market area, including the impact of the impairment of securities; political actions, including failure of the United States Congress to raise the federal debt ceiling or the imposition of changes in the federal budget; changes in customer preferences and consumer behavior; increased competitive pressures or changes in either the nature or composition of competitors; changes in the legal and regulatory environment; changes in factors influencing liquidity, such as expectations regarding the rate of inflation or deflation, currency exchange rates, and other factors influencing market volatility; changes in assumptions underlying the establishment of reserves for possible loan losses, reserves for repurchase of mortgage loans sold and other estimates; and risks associated with other global economic, political and financial factors.

While actual results may differ significantly from the results discussed in the forward-looking statements, the Company undertakes no obligation to update publicly any forward-looking statement for any reason, even if new information becomes available.

### Analysis of Assets, Liabilities and Shareholders’ Equity

Due to the seasonality of the loan and deposit balances in the year-end balance sheet, a comparison of September 30, 2015 is included in the analysis of assets and liabilities, in addition to the usual comparison to December 31, 2015. The following table contains the loan and deposit balances referenced in the discussions:

(Amounts in thousands)		
September	December	September
30,	31,	30,

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	2016	2015	2015
Loans:			
Commercial	\$61,351	\$84,613	\$56,904
Commercial real estate	251,149	237,137	232,977
Residential real estate	56,229	45,414	42,880
Consumer - home equity	24,095	23,334	22,953
Consumer - other	2,939	3,756	4,120
Total loans	\$395,763	\$394,254	\$359,834
Total earning assets	\$578,283	\$570,364	\$529,843
Total assets	\$621,162	\$612,443	\$570,250
Deposits:			
Noninterest-bearing deposits	\$112,996	\$108,144	\$98,701
Interest-bearing demand deposits	259,034	256,433	225,320
Time deposits	136,422	131,827	130,526
Total deposits	\$508,452	\$496,404	\$454,547
Total interest bearing liabilities	\$437,424	\$437,914	\$405,720

Earning assets are comprised of deposits at financial institutions, including the Federal Reserve Bank, investment securities and loans. Earning assets were \$578.3 million at September 30, 2016, an increase of 1.4% from the December 31, 2015 balance of \$570.4 million. The increase from December 31, 2015 was mainly due to an increase in loans of \$1.5 million, a decrease of \$8.1 million in trading securities offset by an increase of \$10.2 million in investment securities and an increase in interest-earning deposits of \$4.3 million. Earning assets increased 9.1% from the September 30, 2015 balance of \$529.8 million, which was due mainly to an increase in loans of \$35.9 million and an increase in net investments of \$4.3 million. Total assets of \$621.2 million at September 30, 2016 increased by \$8.7 million, or 1.4%, from the asset total of \$612.4 million at December 31, 2015, and increased \$50.9 million, or 8.9%, from the asset total of \$570.3 million at September 30, 2015.

At September 30, 2016, the investment securities available-for-sale portfolio was \$164.1 million compared to \$153.9 million at December 31, 2015, an increase of \$10.2 million, or 6.7%. Investment securities available-for-sale represented 28.4% of earning assets at September 30, 2016, compared to 27.0% at December 31, 2015. As the Company manages its balance sheet for loan growth, asset mix, liquidity and current interest rates and interest rate forecasts, the investment portfolio is a primary source of liquidity. The investment securities available-for-sale portfolio represented 32.3% of each deposit dollar at September 30, 2016, up from 31.0% of year-end levels.

The investment securities available-for-sale portfolio had net unrealized gains, net of tax, of \$606,000 at September 30, 2016, an increase of \$753,000 compared to net unrealized losses, net of tax, of \$147,000 at December 31, 2015. The securities valuation reflects the decline in mid and long term interest rates over the nine months.

The Company had an investment in trading securities of \$8.1 million at December 31, 2015. The trading account was liquidated at the end of the second quarter. The funds were reinvested into the available-for-sale portfolio.

Loans held for sale remained stable at \$4.0 million at both September 30, 2016 and December 31, 2015.

Total loans at September 30, 2016 were \$395.8 million compared to \$394.3 million at December 31, 2015, a 0.4% increase, and \$359.8 million at September 30, 2015, a 10.0% increase. Year-end loan balances included 90-day or less term commercial loans totaling \$24.2 million that closed in December 2015 and were fully secured by segregated deposit accounts with the Bank, and matured in the first quarter of 2016. Excluding these seasonal loans at December 31, 2015, total loans actually increased \$25.7 million, or 6.9% through September 30, 2016. The Company continues its objective of shifting its asset mix into in-market commercial loans with the intent of improving net interest margin. Total gross loans as a percentage of earning assets stood at 68.4% as of September 30, 2016, 69.1% as of December 31, 2015 and 67.9% as of September 30, 2015. The total loan-to-deposit ratio was 78.6% at September 30, 2016, 80.2% at December 31, 2015 and 79.9% at September 30, 2015.

The allowance for loan losses of \$4.9 million and \$5.2 million, respectively, represented approximately 1.2% of outstanding loans at September 30, 2016 and 1.3% at December 31, 2015. Excluding the year-end, 90-day or less, cash-secured loans, to which none of the allowance was allocated, the allowance for loan losses represented approximately 1.4% of outstanding loans. The allowance for loan losses at September 30, 2015 of \$5.2 million represented approximately 1.4% of outstanding loans. The decrease in the allowance in 2016 was due in part to the favorable outcome of a credit relationship that had specific reserves allocated prior to the third quarter of 2016.

During the first nine months, loan charge-offs were \$548,000 in 2016 compared to \$657,000 for the same period in 2015, while the recovery of previously charged-off loans amounted to \$219,000 in 2016 and \$241,000 in 2015. The net charge-offs represent less than 20 basis points of average loans for 2016 and 2015. Charge-offs of specific problem loans, as well as for smaller balance homogeneous loans, are recorded periodically during the year. The number of loan accounts and the amount of charge-offs associated with account balances vary from period to period as loans are deemed uncollectible by management. Nonaccrual loans were \$2.3 million at September 30, 2016, which is

lower than the \$4.9 million at December 31, 2015, or 0.6% and 1.2%, respectively, of total loans, and lower than \$4.9 million, or 1.4%, of total loans at September 30, 2015. The decrease in nonaccrual loans was also attributable to the favorable outcome of a credit relationship that was in nonaccrual.

Bank-owned life insurance had a cash surrender value of \$17.3 million at September 30, 2016 and December 31, 2015. Comprising approximately 25% of capital, management does not intend to make any significant insurance purchases.

Other assets increased slightly to \$13.6 million at September 30, 2016 from \$12.3 million at December 31, 2015. At September 30, 2016, a \$4.2 million investment in a partnership fund is included in other assets compared to \$3.6 million at December 31, 2015, with an offsetting \$3.0 million at June 30, 2016 and \$2.4 million at December 31, 2015 in other liabilities, which is the commitment to fund this affordable housing investment. Also included in other assets is an investment of \$2.0 million into a privately managed pooled fund of small business administration loans at September 30, 2016 and December 31, 2015.

Noninterest-bearing deposits measured \$113.0 million at September 30, 2016 compared to \$108.1 million at December 31, 2015 and \$98.7 million at September 30, 2015. Interest-bearing deposits increased \$7.2 million to \$395.5 million at September 30, 2016 from \$388.3 million at December 31, 2015 and \$39.7 million from \$355.8 at September 30, 2015. The increase in interest-bearing deposits from year end is net of segregated money market deposit accounts with the Bank which fully collateralized \$24.2 million in 90-day or less term commercial loans that closed in December 2015. The loans matured and the deposits withdrew in the first quarter of 2016. Absent the collateral deposits, interest-bearing deposits increased \$31.4 million, or 8.6%, over the first nine months of 2016.

Federal Home Loan Bank advances and short-term borrowings decreased to \$36.8 million at September 30, 2016 from \$44.5 million at December 31, 2015. Management continues to use short-term borrowings to bridge its current cash flow needs resulting in variations from period to period. During 2016, the Company paid off \$4.5 million in long term debt with an average cost of 4%. Other liabilities measured \$10.4 million at September 30, 2016 and \$9.7 million at December 31, 2015. Included in other liabilities in 2016 is \$723,000 in securities purchased in September with settlement dates in October.

The Company improved its capital levels in the first nine months of 2016. The Company's total shareholders' equity measured \$60.3 million at September 30, 2016 and \$56.7 million on December 31, 2015. The Company's capital continues to meet the requirements for the Company to be deemed well-capitalized under all regulatory measures.

Cash dividends of \$0.21 per share were paid to shareholders of record to date in 2016. Cash dividends of \$0.24 per share were paid to shareholders of record in 2015, with \$0.18 in the first nine months of 2015.

#### Capital Resources

The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors, and the regulators can lower classifications in certain cases. Failure to meet various capital requirements can initiate regulatory action that could have a direct material effect on the financial statements.

The prompt corrective action regulations provide five categories, including well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If a bank is only adequately capitalized, regulatory approval is required to, among other things, accept, renew or roll-over brokered deposits. If a bank is undercapitalized, capital distributions and growth and expansion are limited, and plans for capital restoration are required.

In July 2013, the Board of Governors of the Federal Reserve Board and the FDIC approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (commonly known as Basel III). Under the final rules, which began for the Company and the Bank on January 1, 2015 and are subject to a phase-in period through January 1, 2019, minimum requirements will increase for both the quantity and quality of capital held by the Company and the Bank. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio (CET1 ratio) of 4.5% and a capital conservation buffer of 2.5% of risk-weighted assets, which when fully



phased-in, effectively results in a minimum CET1 ratio of 7.0%. Basel III raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% (which, with the capital conservation buffer, effectively results in a minimum Tier 1 capital ratio of 8.5% when fully phased-in), effectively results in a minimum total capital to risk-weighted assets ratio of 10.5% (with the capital conservation buffer fully phased-in), and requires a minimum leverage ratio of 4.0%. Basel III also makes changes to risk weights for certain assets and off-balance-sheet exposures. Management expects that the capital ratios for the Company and the Bank under Basel III will continue to exceed the well capitalized minimum capital requirements, as they currently exceed the fully phased in 2019 requirements.

At September 30, 2016 and December 31, 2015, actual capital levels and minimum required levels were:

(Dollars in thousands)						
	Actual		Minimum required for capital adequacy purposes		To be well-capitalized under prompt corrective action regulations	
September 30, 2016	Amount	Ratio	Amount	Ratio	Amount	Ratio
CET1 capital (to risk-weighted assets)						
Company	\$59,760	12.87 %	\$23,790	5.125 %	N/A	N/A
Bank	55,862	12.12 %	23,617	5.125 %	\$29,953	6.5 %
Tier 1 capital (to risk-weighted assets)						
Company	64,760	13.95 %	30,753	6.625 %	N/A	N/A
Bank	55,862	12.12 %	30,529	6.625 %	36,865	8.0 %
Total capital (to risk-weighted assets)						
Company	69,759	15.03 %	40,038	8.625 %	N/A	N/A
Bank	66,861	14.51 %	39,746	8.625 %	46,082	10.0 %
Tier 1 capital (to average assets)						
Company	64,760	10.62 %	24,381	4.0 %	N/A	N/A
Bank	55,862	9.22 %	24,231	4.0 %	30,288	5.0 %

(Dollars in thousands)						
	Actual		Minimum required for capital adequacy purposes		To be well-capitalized under prompt corrective action regulations	
December 31, 2015	Amount	Ratio	Amount	Ratio	Amount	Ratio
CET1 capital (to risk-weighted assets)						
Company	\$56,922	12.78 %	\$20,043	4.5 %	N/A	N/A
Bank	53,086	12.01 %	19,887	4.5 %	\$28,726	6.5 %
Tier 1 capital (to risk-weighted assets)						
Company	61,922	13.90 %	26,723	6.0 %	N/A	N/A
Bank	53,086	12.01 %	26,517	6.0 %	35,355	8.0 %
Total capital (to risk-weighted assets)						
Company	67,199	15.09 %	35,631	8.0 %	N/A	N/A
Bank	64,363	14.56 %	35,355	8.0 %	44,194	10.0 %
Tier 1 capital (to average assets)						
Company	61,922	10.62 %	23,314	4.0 %	N/A	N/A
Bank	53,086	9.17 %	23,163	4.0 %	28,954	5.0 %

The Company had \$5.0 million of trust preferred securities at both September 30, 2016 and December 31, 2015 that qualified as Tier 1 capital. Refer to Note 7, "Subordinated Debt."

The Bank was categorized as "well capitalized" at September 30, 2016 and December 31, 2015.

#### Certain Non-GAAP Measures

Certain financial information has been determined by methods other than Generally Accepted Accounting Principles (GAAP). Specifically, certain financial measures are based on core earnings rather than net income. Core earnings exclude income, expense, gains and losses that either are not reflective of ongoing operations or that are not expected to reoccur with any regularity or reoccur with a high degree of uncertainty and volatility. Such information may be useful to both investors and management and can aid them in understanding the Company's current performance trends and financial condition. Core earnings are a supplemental tool for analysis and not a substitute for GAAP net income. Reconciliation from GAAP net income to the non-GAAP measure of core earnings is referenced as part of management's discussion and analysis of financial condition and results of operations.

Core earnings, which exclude certain non-recurring items, increased for the nine months ended September 30, 2016 as compared to the nine months ended September 30, 2015. Core earnings for the first nine months of 2016 were \$3.6 million, or \$0.82 per share, compared to \$3.3 million, or \$0.73 per share for the first nine months of 2015. Core earnings for both the third quarter of 2016 and 2015 were \$1.2 million, or \$0.27 per share.

The following is the reconciliation between core earnings and earnings under GAAP.

	(Amounts in thousands, except per share amounts)			
	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
GAAP earnings	\$1,195	\$1,227	\$3,730	\$3,292
Investment gains not in the ordinary course of business (net of tax)	—	—	(191 )	—
Net losses from the extinguishment of debt (net of tax)*	—	—	160	—
Reversal of deferred tax valuation allowance	—	—	(93 )	—
Core earnings	\$1,195	\$1,227	\$3,606	\$3,292
Core earnings per share	\$0.27	\$0.27	\$0.82	\$0.73

\*Loss on the early payoff of FHLB long term debt

#### Analysis of Net Interest Income – Nine months ended September 30, 2016 and 2015

Net interest income, the principal source of the Company's earnings, is the amount by which interest and fees generated by interest-earning assets, primarily loans and investment securities, exceed the interest cost of deposits and borrowed funds. On a fully taxable equivalent basis, net interest income measured \$15.3 million for September 30, 2016 and \$14.5 million for September 30, 2015. The resulting net interest margin was 3.66% for both periods ended September 30, 2016 and 2015.

The increase in interest income, on a fully taxable equivalent basis, of \$1.1 million is the product of a 6.1% year-over-year increase in average earning assets supplemented by a 2 basis point increase in yield. The increase in interest expense of \$226,000 was a product of a 4 basis point increase in rates paid and a 4.5% increase in average interest-bearing liabilities. The net result was a 6.0% increase in net interest income on a fully taxable equivalent basis, with no change to the Company's net interest margin on a growing asset base with a different mix.

On a fully taxable equivalent basis, income on investment securities available-for-sale and trading decreased by \$184,000, or 4.8%. The average invested balances in these securities decreased by \$4.3 million, or 2.6%, from the levels of a year ago. The decrease in the average balance of investment securities was accompanied by a 6 basis point decrease in the tax equivalent yield of the portfolio. The decline in securities average balances during 2016 was the result of selling \$10.3 million in late January to harvest gains to offset the prepayment penalties for the early payoff of FHLB notes. The reinvestment of the \$10.3 million occurred over a six-week period and maintained the average yield of the portfolio. The trading account was liquidated at the end of the second quarter. The Company will continue attempting to redeploy liquidity into loans which generate greater yields than securities.

On a fully taxable equivalent basis, income on loans increased by \$1.3 million, or 10.0%, for September 30, 2016 compared to the same period in 2015. Supplementing this increase was the collection of \$296,000 of interest and fees on a nonperforming loan settled favorably in bankruptcy. A \$33.9 million increase in the average balance of the loan

portfolio, or 9.6%, was accompanied by a 1 basis point increase in the portfolio's tax equivalent yield. Without the collection of the past due interest, portfolio yield would have declined 10 basis points. New loan volume is near historic low interest rates, while strong competition for good credits also drives rates downward. The commercial loan portfolio housed the majority of the increase in balances.

Other interest income increased by \$20,000, or 153.8%, from the same period a year ago. The average balance of interest-earning deposits increased by \$2.3 million, or 41.1%. The yield increased by 24 points from 2015 to 2016, reflecting the late December rise in the federal funds rate. Management intends to remain fully invested, minimizing on-balance sheet liquidity.

Average interest-bearing demand deposits and money market accounts increased by \$26.3 million, or 24.6%, for the nine months ended September 30, 2016 compared to the same period of 2015, while average savings balances decreased by \$165,000, or 0.1%. Total interest paid on interest-bearing demand deposits and money market accounts was \$303,000, an \$115,000 increase from last year. The yield increased 6 basis points from the nine months ended September 30, 2015 to September 30, 2016. Total interest paid on savings accounts was \$58,000, a \$9,000 increase from last year. The average rate paid on savings accounts was 0.07% for the nine months ended September 30, 2016 and 2015. The average balance of time deposit products increased by \$1.3 million, or 1.0%, as the average rate paid increased by 16 basis points, from 1.00% to 1.16%. Interest expense increased on time deposits by \$187,000 from the prior year. The current low-rate environment offers little opportunity for time deposit customers, except for periodic special rates offered on a limited basis.

Average borrowings and subordinated debt decreased by \$9.2 million while the average rate paid increased by 13 basis points. The Company elected to pay off two of its longest maturity FHLB notes, \$4.5 million at an average rate of 4%. Of the \$358,000 in securities gains, \$289,000 was to offset the \$242,000 prepayment penalty on this early payoff. Alternative funding of \$3.5 million at 1.44% was used to replace the borrowings. Annualized interest expense savings of \$130,000 is expected from the transaction. Four long-term FHLB notes remain at an average rate of 4.15%, all maturing by September of 2017 which is expected to reduce 2017 funding costs by \$300,000. Management continues to utilize short-term borrowings to bridge liquidity gaps.

#### Impairment Analysis of Investment Securities

The Company owns two trust preferred securities totaling \$2.0 million (original face) consisting of collateral issued by banks, thrifts, and insurance companies. The market for these securities at September 30, 2016 is not fully active and markets for similar securities are also not completely active. Given conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, the Company determined the few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at September 30, 2016. It was decided that an income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs continues to be more representative of fair value than the market approach valuation technique used at measurement dates prior to 2008.

The Company enlisted the aid of an independent third party to perform the trust preferred securities valuations. The approach to determining fair value involved the following process:

1. Estimate the credit quality of the collateral using average probability of default values for each issuer (adjusted for rating levels).
2. Consider the potential for correlation among issuers within the same industry for default probabilities (e.g. banks with other banks).
3. Forecast the cash flows for the underlying collateral and apply to each trust preferred security tranche to determine the resulting distribution among the securities.
4. Discount the expected cash flows to calculate the present value of the security.

The effective fair value discount rates are highly dependent upon the credit quality of the collateral, the relative position of the tranche in the capital structure of the trust preferred securities and the prepayment assumptions. The PreTSL XXIII cash flows are discounted at 15.30% through its maturity date of December 2036 and would have to experience an additional \$220 million of nonperforming collateral (of \$857 million performing) in order to incur any impairment. The aggregate cash flows for the C-2 tranche are estimated to be \$39.8 million on a current principal of \$26.3 million. The Trapeza IX cash flows are discounted at 9.00% through its maturity of January 2038 and would experience additional impairment upon further occurrence of nonperforming collateral of \$20 million (of \$213 million performing). The aggregate cash flows for the B-1 tranche are estimated to be \$38.4 million on a current principal of \$23.7 million.

Based upon the results of the analysis, the Company currently believes that a weighted average price of approximately \$0.37 per \$1.00 of par value is representative of the fair value of the two trust preferred securities, with individual securities therein ranging from \$0.29 to \$0.44.

The Company considered all information available as of September 30, 2016 to estimate the impairment and resulting fair value of the trust preferred securities. These securities are supported by a number of banks and insurance companies located throughout the country. While the number of bank failures has declined since the historically high failure rates of 2009, 2010 and 2011, there is still the potential for troubled banks to fail. The Company did not

recognize any credit related impairment in the first nine months of 2016 or 2015. If the conditions of the underlying banks in the trust preferred securities worsen, there may be additional impairment to recognize in 2016 or later.

Analysis of Provision for Loan Losses, Non-Interest Income, Non-Interest Expense and Federal Income Tax - Nine Months Ended September 30, 2016 and 2015

During the first nine months of both 2016 and 2015, the amount charged to operations as a provision for loan losses was adjusted to account for charge-offs against the allowance, as well as an increase in loan balances recorded in the portfolio, expected losses on specific problem loans and several qualitative factors, including factors specific to the local economy and to industries operating in the local market. The Company has allocated a portion of the allowance for a number of specific problem loans through 2016 and 2015, but has not experienced significant deterioration in any loan type, including the residential real estate portfolios or the commercial loan portfolio, and accordingly has not added any special provision for these loan types. Because of the favorable outcome of a credit relationship that had a specific reserve in place that was removed, for the nine months ended September 30, 2016 there was only \$50,000 additional provision booked. There was a favorable ruling in a bankruptcy court surrounding the eventual sale of a business to which the Company lent funds, \$2.1 million of which was included in nonaccrual loans. The Company resolved a substantial portion of the delinquent loan, allowing the portion of the allowance for loan losses allocated to this credit to be used for other problem loans. For the same period in 2015, the provision was \$390,000. Provision expense levels are in recognition of loan growth and a changing composition of the loan portfolio as the Company manages its balance sheet with a commercially-oriented focus.

Total non-interest income, excluding investment gains and losses, increased by \$339,000 or 11.5%, for September 30, 2016 compared to September 30, 2015. After gains and losses on investment securities, non-interest income increased by \$733,000, or 24.8%, in the first nine months of 2016 compared to the first nine months of 2015.

Gains on securities called and net gains on the sale of available-for-sale investment securities increased by \$461,000 in the first nine months of 2016 from year ago levels. Included in the total is \$289,000 of gains generated to offset losses from the extinguishment of debt. Trading security losses of \$47,000 were recorded in 2016, a decrease in income of \$67,000 from the gain of \$20,000 recorded in 2015, reflective of the decline in the secondary market activity for municipal securities in which the trading account operated. At the end of June the trading account was liquidated.

Mortgage banking gains increased to \$1.2 million at September 30, 2016 from \$636,000 at September 30, 2015, an increase of \$519,000 reflecting the increase in mortgage loan originations spurred by the improving housing market and the Company's geographic expansion. Wealth management income of \$50,000 was recorded in 2016, compared to \$363,000 in 2015, a decrease of \$313,000. The Bank, which had operated a non-deposit investment services program, launched its new Cortland Private Wealth Management program, which offers a full suite of program options, including private asset management, financial and estate planning, retirement plans, insurance and advisory services. The new program, which was introduced in late January will ramp up over the remaining course of the year and into 2017, adding contributions from both investment and advisory services. Other sources of non-interest income increased by \$133,000 from the same period a year ago. This latter income category is subject to fluctuation due to the non-recurring nature of some of the items. This was due in part to income generated from the new Kasasa suite of products.

Total non-interest expenses in the first nine months were \$13.7 million in 2016 compared to \$12.2 million in 2015, an increase of \$1.5 million, or 12.5%. During the first nine months of 2016, expenditures for salaries and employee benefits increased by \$627,000, or 9.0%, from the similar period a year ago. The personnel increase was primarily due to the new branch opened in September 2015 and initiatives to geographically expand mortgage origination, commercial lending and private banking. The increase was partially offset by compensation relative to wealth management decreasing commensurate to the decreased revenues. Full time equivalent employment averaged 159



during the first nine months of 2016 and 151 during the first nine months of 2015. In 2016, there was a one-time loss from the extinguishment of debt of \$242,000. This loss is related to the early payoff of long term advances with the Federal Home Loan Bank and was offset by securities gains. Additionally, payoff of this debt will result in annual savings in interest expense of \$130,000. Advertising and marketing expense increased by \$137,000, or 51.7%. The increase is due to the initiative to rebrand the Bank, increased community support and advertising and promoting the new Kasasa suite of products.

All other expense categories increased by \$520,000, or 10.6%, in the aggregate. Contributing to increased expenses in the nine months ending September 30, 2016 are expenses relating to a new full service branch which opened in September of 2015, and two financial service centers which opened in 2015.

The effective tax rate for the first nine months was 18.6% in 2016 and 21.4% in 2015, resulting in income tax expense of \$854,000 in 2016 and \$896,000 in 2015. The 2015 effective rate is normalized based on the current rate of profitability and tax free components of the revenue stream. A \$93,000 reversal of a deferred tax valuation reserve, recognized in 2016, contributed to the lower effective tax rate in 2016.

The provision for income taxes differs from the amount of income tax determined applying the applicable U.S. statutory federal income tax rate (34%) to pre-tax income as a result of the following differences:

	(Amounts in thousands)			
	September 30,		2015	
	2016		2015	
	Balance	%	Balance	%
Provision at statutory rate	\$1,559	34.0	\$1,424	34.0
Add (Deduct) tax effects of:				
Earnings on bank-owned life insurance-net	(86 )	(1.9 )	(87 )	(2.1 )
Non-taxable interest income	(461 )	(10.1 )	(455 )	(10.9 )
Deferred tax valuation reversal	(93 )	(2.0 )	—	—
Low income housing tax credits	(108 )	(2.4 )	(50 )	(1.2 )
Non-deductible expenses	43	1.0	64	1.6
Federal income tax expense	\$854	18.6	\$896	21.4

#### Analysis of Net Interest Income – Three months ended September 30, 2016 and 2015

Net interest income, the principal source of the Company's earnings, is the amount by which interest and fees generated by interest-earning assets, primarily loans and investment securities, exceed the interest cost of deposits and borrowed funds. On a fully taxable equivalent basis, net interest income measured \$5.1 million for the quarter ended September 30, 2016 and \$4.9 million for September 30, 2015. The resulting net interest margin was 3.63% for September 30, 2016 and 3.67% for September 30, 2015.

The increase in interest income, on a fully taxable equivalent basis, of \$373,000 is the product of a 7.0% year-over-year increase in average earning assets offset by a 1 basis point decrease in yield. The increase in interest expense of \$94,000 was a product of a 5 basis point increase in rates paid and a 5.9% increase in average interest-bearing liabilities. The net result was a 5.7% increase in net interest income on a fully taxable equivalent basis, and a 4 basis point decrease in the Company's net interest margin on a growing asset base with a different mix.

On a fully taxable equivalent basis, income on investment securities available-for-sale and trading decreased by \$56,000, or 4.6%. The average invested balances in these securities increased by \$1.0 million, or 0.6%, from the levels of a year ago. The increase in the average balance of investment securities was accompanied by a 15 basis point decrease in the tax equivalent yield of the portfolio. The Company will continue attempting to redeploy liquidity into loans which generate greater yields than securities.

On a fully taxable equivalent basis, income on loans increased by \$422,000, or 9.8%, for September 30, 2016 compared to the same period in 2015. A \$33.5 million increase in the average balance of the loan portfolio, or 9.2%, was accompanied by a 3 basis point increase in the portfolio's tax equivalent yield. New loan volume is near historic low interest rates, while strong competition for good credits also drives rates downward. The commercial loan portfolio housed the majority of the increase in balances.

Other interest income increased by \$7,000, or 175.0%, from the same period a year ago. The average balance of interest-earning deposits increased by \$2.8 million, or 54.3%. The yield increased by 25 points from 2015 to 2016, reflecting the late December rise in the federal funds rate. Management intends to remain fully invested, minimizing on-balance sheet liquidity.

Average interest-bearing demand deposits and money market accounts increased by \$29.0 million, or 26.6%, for the three months ended September 30, 2016 compared to the same period of 2015, while average savings balances decreased by \$777,000, or 0.7%. Total interest paid on interest-bearing demand deposits and money market accounts was \$112,000, a \$43,000 increase from last year. The yield increased 7 basis points from the three months ended September 30, 2015 to September 30, 2016. Total interest paid on savings accounts was \$20,000, a \$3,000 increase from last year. The average rate paid on savings accounts was 0.07% for the three months ended September 30, 2016 compared to 0.06% for the same period in 2015. The average balance of time deposit products increased by \$3.6 million, or 2.8%, as the average rate paid increased by 19 basis points, from 0.99% to 1.18%. Interest expense increased on time deposits by \$77,000 from the prior year. The current low-rate environment offers little opportunity for time deposit customers, except for periodic special rates offered on a limited basis.

Average borrowings and subordinated debt decreased by \$8.1 million while the average rate paid increased by 8 basis points. In January 2016, the Company elected to pay off two of its longest maturity FHLB notes, \$4.5 million at an average rate of 4%. Alternative funding of \$3.5 million at 1.44% was used to replace the borrowings. Annualized interest expense savings of \$130,000 is expected from the transaction. Four long-term FHLB notes remain at an average rate of 4.15%, all maturing by September of 2017 which is expected to reduce 2017 funding costs by \$300,000. Management continues to utilize short-term borrowings to bridge liquidity gaps.

Analysis of Provision for Loan Losses, Non-Interest Income and Non-Interest Expense – Third Quarter Ended September 30, 2016 and 2015

For the third quarter ended September 30, 2016, there were net recoveries of \$5,000. A provision for loan losses of \$50,000 was recorded in the quarter. For the same period in 2015, the provision was \$100,000, an amount less than the net charge-offs of \$378,000 for the quarter because a charge-off of \$468,000 already had a specific reserve assigned to it for an equal amount recorded in 2014. Provision expense levels are in recognition of loan growth and a changing composition of the loan portfolio as the Company manages its balance sheet with a commercially-oriented focus.

Total non-interest income, excluding investment gains and losses, increased by \$38,000, or 3.8%, for September 30, 2016 compared to September 30, 2015. After gains and losses on investment securities, non-interest income increased by \$74,000, or 7.1%, in the third quarter of 2016 compared to the third quarter of 2015.

Gains on securities called and net gains on the sale of available-for-sale investment securities increased by \$86,000 in the third quarter of 2016 from year ago levels. Trading security gains of \$50,000 were recorded in 2015, and none recorded in 2016. The Company elected to liquidate the trading account at June 30, 2016.

Mortgage banking gains accounted for the majority of the increase in non-interest income. In the third quarter, mortgage banking income increased to \$341,000 at September 30, 2016 from \$291,000 at September 30, 2015, an increase of \$50,000 reflecting the increase in mortgage loan originations spurred by the improving housing market and the Company's geographic expansion. Wealth management income of \$10,000 was recorded in 2016, compared to \$56,000 in 2015, a decrease of \$46,000. The Bank, which had operated a non-deposit investment services program, launched its new Cortland Private Wealth Management program, which offers a full suite of program options, including private asset management, financial and estate planning, retirement plans, insurance and advisory services. The new program, which was introduced in late January is expected to ramp up over the remaining course of the year and into 2017, adding contributions from both investment and advisory services. Other sources of non-interest income increased by \$34,000 from the same period a year ago. This latter income category is subject to fluctuation due to the non-recurring nature of some of the items.

Total non-interest expenses in the third quarter were \$4.5 million in 2016 compared to \$4.0 million in 2015, an increase of \$489,000, or 12.3%. During the third quarter of 2016, expenditures for salaries and employee benefits increased by \$470,000, or 21.7%, from the similar period a year ago. The personnel increase was primarily due to the new branch opened in September 2015 and initiatives to geographically expand mortgage origination, commercial lending and private banking. These increases were offset partially by compensation relative to wealth management decreasing commensurate to the decreased revenues. Full time equivalent employment averaged 168 during the third quarter of 2016 and 151 during the third quarter of 2015.

All other expense categories increased by \$19,000, or 1.0%, in the aggregate. These expenses are subject to fluctuation due to non-recurring items.

## Liquidity

The central role of the Company's liquidity management is to (1) ensure sufficient liquid funds to meet the normal transaction requirements of its customers, (2) take advantage of market opportunities requiring flexibility and speed, and (3) provide a cushion against unforeseen liquidity needs.

Liquidity risk arises from the possibility that the Company may not be able to satisfy current or future financial commitments or may become unduly reliant on alternative funding sources. The objective of liquidity management is to ensure the Company has the ability to fund balance sheet growth and meet deposit and debt obligations in a timely and cost-effective manner. Management monitors liquidity through a regular review of asset and liability maturities, funding sources, and loan and deposit forecasts. The Company maintains strategic and contingency liquidity plans to ensure sufficient available funding to satisfy requirements for balance sheet growth, proper management of capital markets funding sources and addressing unexpected liquidity requirements.

Principal sources of liquidity available to the Company include assets considered relatively liquid, such as interest-bearing deposits in other banks, federal funds sold and, cash and due from banks, as well as cash flows from maturities and repayments of loans, investment securities and mortgage-backed securities.

Principal repayments on mortgage-backed securities, collateralized mortgage obligations and small business administration pools, along with investment securities maturing or called amounted to \$15.7 million in the third quarter of 2016 which annualized represents 12.8% of the total combined portfolio, compared to \$14.6 million, or 12.9% of the portfolio a year ago. A large portion of the investment portfolio is allocated to amortizing debt in order to provide cash flows to supplement loan growth.

In order to address the concern of FDIC insurance of larger depositors, the Bank is a member of the Certificate of Deposit Account Registry Service (CDARS®) program and the Insured Cash Sweep (ICS) program. Through CDARS®, the Bank's customers can increase their FDIC insurance by up to \$50 million through reciprocal certificate of deposit accounts and likewise through ICS, they can accomplish the same through money market savings accounts. This is accomplished by the Bank entering into reciprocal depository relationships with other member banks. The individual customer's large deposit is broken into amounts below \$250,000 and placed with other banks that are members of the network. The reciprocal member bank issues certificates of deposit or money market savings accounts in amounts that ensure that the entire deposit is eligible for FDIC insurance. At September 30, 2016, the Bank had \$24.5 million of deposits in the CDARS® program, and had \$5.7 million of deposits in the ICS money market program. For regulatory purposes, CDARS® and ICS are considered a brokered deposit.

Along with its liquid assets, the Bank has other sources of liquidity available to it which help to ensure that adequate funds are available as needed. These other sources include, but are not limited to, the ability to obtain deposits through the adjustment of interest rates, the purchasing of federal funds, correspondent bank lines of credit and access to the Federal Reserve Discount Window. The Bank is also a member of the Federal Home Loan Bank of Cincinnati, which provides its largest source of liquidity. At September 30, 2016, the Bank had approximately \$19.5 million available of collateral-based borrowing capacity at FHLB of Cincinnati, supplementing the \$5.5 million of availability with the Federal Reserve Discount window. Additionally, the FHLB has committed a \$30.1 million cash management line, of which nothing has been disbursed, subject to posting additional collateral. The Bank, by policy, has access to approximately 15% of total deposits in various forms of wholesale deposits that could be used as an additional source of liquidity. At September 30, 2016, there was \$27.7 million in outstanding balances in wholesale deposits including internet-based deposits with access to an additional \$48.6 million. The Company was also granted a total of \$8.5 million in unsecured, discretionary Federal Funds lines of credit with no funds drawn upon as of September 30, 2016. Unpledged securities of \$48.8 million are also available for borrowing under repurchase agreements or as additional collateral for FHLB lines of credit or to sell to generate liquidity.

The Company has other more limited sources of liquidity. In addition to its existing liquid assets, it can raise funds in the securities market through debt or equity offerings or it can receive dividends from its bank subsidiary. Generally, the Bank may pay dividends without prior approval as long as the dividend is not more than the total of the current calendar year-to-date earnings plus any earnings from the previous two years not already paid out in dividends, as long as the Bank remains well-capitalized after the dividend payment. The amount available for dividend at September 30, 2016 is \$7.2 million. Future dividend payments by the Bank to the Company are based upon future earnings. The Holding Company had cash of \$408,000 at September 30, 2016 available to meet cash needs. It also held a \$6.0 million note receivable, the cash flow from which approximates the debt service on the Junior Subordinated Debentures. Cash is generally used by the Holding Company to pay quarterly interest payments on the debentures, pay dividends to common shareholders, repurchase shares, and to fund operating expenses.

Cash and cash equivalents increased to \$22.3 million at September 30, 2016 compared to \$14.3 million at September 30, 2015 and \$18.5 million at December 31, 2015, as the Company strives to be fully invested, minimizing on balance sheet liquidity.

The following table details the cash flow from operating activities for the nine months ended:

(Amounts in  
thousands)  
September 30,  
2016      2015

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Net income	\$3,730	\$3,292
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation, amortization and accretion	2,006	1,904
Provision for loan losses	50	390
Investment securities available-for-sale (gains) losses, net	(458 )	3
Other real estate gains, net	(13 )	—
Originations of mortgage banking loans held for sale	(41,286)	(28,475)
Proceeds from the sale of mortgage banking loans	42,435	26,621
Mortgage banking gains, net	(1,155 )	(636 )
Decrease (increase) in trading account	8,134	(222 )
Earnings on bank-owned life insurance	(253 )	(255 )
Equity compensation	57	—
Changes in:		
Deferred taxes	(86 )	(36 )
Other assets and liabilities	(1,599 )	(1,793 )
Net cash flow from operating activities	\$11,562	\$793

Key variations stem from: 1) Gains were recognized on the sale of available-for-sale investments of \$458,000 in 2016 mainly due to sales made to offset the loss on extinguishment of debt, and a \$3,000 loss recognized in 2015. 2) There was a \$50,000 loan loss provision recorded in 2016 and \$390,000 recorded in 2015. The decreased amount in 2016 is because of a favorable outcome on a credit relationship which the specific reserve previously set aside was able to be used for other problem loans. 3) Loans held for sale increased by \$6,000 in 2016 compared to an increase of \$2.5 million in 2015, with mortgage banking gains of \$1.2 million in 2016 and \$636,000 in 2015 due to the volume in mortgage banking. 4) As of September 2016, the trading account was fully liquidated with a \$8.1 million decrease compared to an increase of \$222,000 in 2015. 5) In 2016, there was \$57,000 in equity compensation as a result of the new compensation program initiated in April 2016. Refer to the Consolidated Statements of Cash Flows for a summary of the sources and uses of cash for 2016 and 2015.

### Critical Accounting Policies and Estimates

The discussion and analysis of the Company's financial condition and results of operation are based upon the Consolidated Financial Statements, which have been prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP). The preparation of these consolidated financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities at the date of the Company's consolidated financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Certain accounting policies involve significant judgments and assumptions by management which has a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances.

Management believes the following are critical accounting policies that require the most significant judgments and estimates used in the preparation of the Company's consolidated financial statements.

#### Accounting for the Allowance for Loan Losses

The determination of the allowance for loan losses and the resulting amount of the provision for loan losses charged to operations reflects management's current judgment about the credit quality of the loan portfolio and takes into consideration changes in lending policies and procedures, changes in economic and business conditions, changes in the nature and volume of the portfolio and, in the terms of loans, changes in the experience, ability and depth of lending management, changes in the volume and severity of past due, non-accrual and adversely classified or graded loans, changes in the quality of the loan review system, changes in the value of underlying collateral for collateral-dependent loans, the existence and effect of any concentrations of credit and the effect of competition, legal and regulatory requirements and other external factors. The nature of the process by which we determine the appropriate allowance for loan losses requires the exercise of considerable judgment. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond our control, including the performance of the loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications. The allowance is increased by the provision for loan losses and decreased by charge-offs when management believes the uncollectibility of a loan is confirmed. Subsequent recoveries, if any, are credited to the allowance. A weakening of the economy or other factors that adversely affect asset quality could result in an increase in the number of delinquencies, bankruptcies or defaults and a higher level of non-performing assets, net charge offs, and provision for loan losses in future periods.



The Company's allowance for loan losses methodology consists of three elements: specific valuation allowances based on probable losses on specific loans; valuation allowances based on historical loan loss experience for similar loans with similar characteristics and trends; and general valuation allowances based on general economic conditions and other qualitative risk factors both internal and external to the Company. These elements support the basis for determining allocations between the various loan categories and the overall adequacy of our allowance to provide for probable losses inherent in the loan portfolio.

With these methodologies, a general allowance is established for each loan type based on historical losses for each loan type in the portfolio. Additionally, management allocates a specific allowance for "Impaired Credits," which is based on current information and events; it is probable the Company will not collect all amounts due according to the original contractual terms of the loan agreement. The level of the general allowance is established to provide coverage for management's estimate of the credit risk in the loan portfolio by various loan segments not covered by the specific allowance. Additional information regarding allowance for credit losses can be found in the Notes to the Consolidated Financial Statements (Note 4) and elsewhere in this Management's Discussion and Analysis.

## Investment Securities and Impairment

The classification and accounting for investment securities is discussed in detail in Note 3 of the Consolidated Financial Statements. Investment securities must be classified as held-to-maturity, available-for-sale, or trading. The appropriate classification is based partially on our ability to hold the securities to maturity and largely on management's intentions, if any, with respect to either holding or selling the securities. The classification of investment securities is significant since it directly impacts the accounting for unrealized gains and losses on securities. Unrealized gains and losses on trading securities, if any, flow directly through earnings during the periods in which they arise, whereas available-for-sale securities are recorded as a separate component of shareholders' equity (accumulated other comprehensive income or loss) and do not affect earnings until realized. The fair values of our investment securities are generally determined by reference to quoted market prices and reliable independent sources. At each reporting date, the Company assesses whether there is an "other-than-temporary" impairment to the Company's investment securities. Such impairment must be recognized in current earnings rather than in other comprehensive income (loss).

The Company reviews investment debt securities on an ongoing basis for the presence of other-than-temporary impairment (OTTI) with formal reviews performed quarterly. OTTI losses on individual investment securities are recognized in accordance with FASB ASC topic 320, Investments – Debt and Equity Securities. The purpose of this ASC is to provide greater clarity to investors about the credit and noncredit component of an OTTI event and to communicate more effectively when an OTTI event has occurred. This ASC amends the OTTI guidance in GAAP for debt securities, improves the presentation and disclosure of OTTI on investment securities and changes the calculation of the OTTI recognized in earnings in the financial statements. This ASC does not amend existing recognition and measurement guidance related to OTTI of equity securities.

For debt securities, ASC topic 320 requires an entity to assess whether it has the intent to sell the debt security or it is more-likely-than-not that it will be required to sell the debt security before its anticipated recovery. If either of these conditions is met, an OTTI on the security must be recognized.

In instances in which a determination is made that a credit loss (defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis) exists but the entity does not intend to sell the debt security and it is not more-likely-than-not that the entity will be required to sell the debt security before the anticipated recovery of its remaining amortized cost basis (i.e., the amortized cost basis less any current-period credit loss), ASC topic 320 changes the presentation and amount of the OTTI recognized in the income statement.

In these instances, the impairment is separated into the amount of the total impairment related to the credit loss and the amount of the total impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total impairment related to all other factors is recognized in other comprehensive income (loss). The total OTTI is presented in the income statement with an offset for the amount of the total OTTI that is recognized in other comprehensive income (loss). In determining the amount of impairment related to credit loss, the Company uses a third party discounted cash flow model, several inputs for which require estimation and judgment. Among these inputs are projected deferral and default rates and estimated recovery rates. Realization of events different than that projected could result in a large variance in the values of the securities.

## Income Taxes

The provision for income taxes is based on income reported for financial statement purposes and differs from the amount of taxes currently payable, since certain income and expense items are reported for financial statement purposes in different periods than those for tax reporting purposes. Accrued taxes represent the net estimated amount

due or to be received from taxing authorities. In estimating accrued taxes, the Company assesses the relative merits and risks of the appropriate tax treatment of transactions taking into account statutory, judicial and regulatory guidance in the context of the Company's tax position.

The Company accounts for income taxes using the asset and liability approach, the objective of which is to establish deferred tax assets and liabilities for the temporary differences between the financial reporting basis and tax basis of our assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled. The Company conducts periodic assessments of deferred tax assets, including net operating loss carryforwards, to determine if it is more-likely-than-not that they will be realized. In making these assessments, the Company considers taxable income in prior periods, projected future taxable income, potential tax planning strategies and projected future reversals of deferred tax items. These assessments involve a certain degree of subjectivity which may change significantly depending on the related circumstances.

#### Available Information

The Company files an annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports with the Securities and Exchange Commission (SEC) pursuant to Section 13(a) or 15(d) of the Exchange Act of 1934

Amended (the Exchange Act). The Company's website is [www.cortlandbank.com](http://www.cortlandbank.com). The Company makes available through its website, free of charge, the reports filed with the SEC, as soon as reasonably practicable after such material is electronically filed, or furnished to, the SEC. The SEC also maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov). The public may read and copy any materials filed with the Commission at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549, on official business days during the hours of 10:00 am to 3:00 pm. The public may obtain information on the operation of the Public Reference Room by calling the Commission at 1-800-SEC-0330.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in the quantitative and qualitative information about market risk from the information provided in the Company's Form 10-K for the year ended December 31, 2015.

### ITEM 4. CONTROLS AND PROCEDURES

**Evaluation of Disclosure Controls and Procedures.** With the supervision and participation by management, including the Company's principal executive officer and principal financial officer, the effectiveness of disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")) has been evaluated as of the end of the period covered by this report. Based upon that evaluation, the Company's principal executive officer and principal financial officer have concluded that these controls and procedures were effective.

**Changes in Internal Control Over Financial Reporting.** Our Chief Executive Officer and Chief Financial Officer have concluded that there have been no significant changes during the period covered by this report in the Company's internal control over financial reporting (as defined in Rules 13a-13 and 15d-15 of the Exchange Act) that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

## PART II—OTHER INFORMATION

### Item 1. Legal Proceedings

See Note (5) of the financial statements.

### Item 1A. Risk Factors

There have been no material changes in the risk factors disclosed by the Company in its Report on Form 10-K for the fiscal year ended December 31, 2015.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds—Not applicable

Company's Common Stock. There were no repurchases of shares of the Company's common stock during the three months ended September 30, 2016.

### Item 3. Defaults upon Senior Securities—Not applicable

### Item 4. Mine Safety Disclosures—Not applicable

### Item 5. Other Information—Not applicable

## CORTLAND BANCORP AND SUBSIDIARIES

## INDEX TO EXHIBITS

Item 6. Exhibits—The following exhibits are filed or incorporated by reference as part of this report:

Exhibit No.	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form**	Exhibit	Filing Date	
3.1	Restated Amended Articles of Cortland Bancorp reflecting amendment dated June 25, 1999. Note: filed for purposes of SEC reporting compliance only. This restated document has not been filed with the State of Ohio.	10-K(1)	3.1	03/16/06	
3.2	Code of Regulations, as amended.	10-K	3.2	03/24/15	
4.1	The rights of holders of equity securities are defined in portions of the Articles of Incorporation and Code of Regulations as referenced in Exhibits 3.1 and 3.2	10-K(1)	4.1	03/16/06	
4.2	Agreement to furnish instruments and agreements defining rights of holders of long-term debt				ü
*10.1	Group Term Carve Out Plan dated February 23, 2001, by The Cortland Savings and Banking Company with each executive officer other than Rodger W. Platt and with selected other officers, as amended by the August 2002 letter amendment	10-K(1)	10.1	03/16/06	
*10.1.1	Amendment of Group Term Carve Out Plan, dated October 28, 2014	8-K	10.1.1	11/03/14	
10.2	[Reserved]				
10.3	[Reserved]				
*10.4	Amended Director Retirement Agreement between Cortland Bancorp and David C. Cole, dated as of December 18, 2007	10-K	10.4	03/17/08	
10.5	[Reserved]				
10.6	[Reserved]				
*10.7	Amended Director Retirement Agreement between Cortland Bancorp and James E. Hoffman III, dated as of December 18, 2007	10-K	10.7	03/17/08	

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*10.8	Amended Director Retirement Agreement between Cortland Bancorp and Neil J. Kaback, dated as of December 18, 2007	10-K	10.8	03/17/08
10.9	[Reserved]			
*10.10	Amended Director Retirement Agreement between Cortland Bancorp and Richard B. Thompson, dated as of December 18, 2007	10-K	10.10	03/17/08
*10.11	Amended Director Retirement Agreement between Cortland Bancorp and Timothy K. Woofter, dated as of December 18, 2007	10-K	10.11	03/17/08
*10.12	Form of Split Dollar Agreement entered into by Cortland Bancorp and each of Directors David C. Cole, James E. Hoffman III, and Timothy K. Woofter as of February 23, 2001, as of March 1, 2004, with Director Neil J. Kaback, and as of October 1, 2001, with Director Richard B. Thompson;	10-K(1)	10.12	03/16/06
	as amended on December 26, 2006, for Directors Cole, Hoffman, Thompson, and Woofter;	10-K	10.12	03/15/07
*10.13	Director's Retirement Agreement between Cortland Bancorp and Director Joseph E. Koch, dated as of April 19, 2011	8-K	10.13	04/22/11

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Exhibit No.	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form**	Exhibit	Filing Date	
*10.14	Split Dollar Agreement and Endorsement between Cortland Bancorp and Director Joseph E. Koch, dated as of April 19, 2011	8-K	10.14	04/22/11	
*10.15	Form of Indemnification Agreement entered into by Cortland Bancorp with each of its directors	10-K(1)	10.15	03/16/06	
*10.16	Endorsement Split Dollar Agreement between The Cortland Savings and Banking Company and David J. Lucido, dated as of March 27, 2012	10-K	10.16	03/29/12	
*10.17	Seventh Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Timothy Carney, dated as of November 24, 2015	8-K	10.17	12/01/15	
*10.18	Third Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and Lawrence A. Fantauzzi, dated as of December 3, 2008	8-K	10.18	12/12/08	
*10.19	Seventh Amended Salary Continuation Agreement between The Cortland Savings and Banking Company and James M. Gasior, dated as of November 24, 2015	8-K	10.19	12/01/15	
10.20	[Reserved]				
10.21	[Reserved]				
10.22	[Reserved]				
*10.23	Salary Continuation Agreement between The Cortland Savings and Banking Company and David J. Lucido, dated as of November 24, 2015	8-K	10.23	12/01/15	
*10.24	Fourth Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and Timothy Carney, dated as of April 19, 2011	8-K	10.24	04/22/11	
*10.25	Salary Continuation Agreement between The Cortland Savings and Banking Company and Stanley P. Feret, dated as of November 24, 2015	8-K	10.25	12/01/15	
*10.26	Fourth Amended Split Dollar Agreement and Endorsement between The Cortland Savings and Banking Company and James M. Gasior, dated as of April 19, 2011	8-K	10.26	04/22/11	
10.27	[Reserved]				



10.28 [Reserved]

10.29 [Reserved]

*10.30	Endorsement Split Dollar Agreement between The Cortland Savings and Banking Company and Stanley P. Feret, dated as of July 23, 2013	10-Q	10.30	08/13/13
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*10.31.1	Severance Agreement between Cortland Bancorp and Tim Carney, dated as of September 28, 2012, as amended November 24, 2015	10-K	10.31.1	12/01/15
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*10.31.2	Severance Agreement between Cortland Bancorp and James Gasior, dated as of September 28, 2012, as amended November 24, 2015	8-K	10.31.2	12/01/15
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*10.31.3	Severance Agreement between Cortland Bancorp and David J. Lucido, dated as of September 28, 2012, as amended November 24, 2015	8-K	10.31.3	12/01/15
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Exhibit No.	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form**	Exhibit	Filing Date	
10.32	[Reserved]				
10.33	[Reserved]				
*10.34	Severance Agreement between Cortland Bancorp and Stanley P. Feret, dated as of September 28, 2012, as amended November 24, 2015	8-K	10.34	12/01/15	
*10.35	Annual Incentive Plan for Executive Officers	8-K	10.35	08/03/15	
*10.36	2015 Omnibus Equity Plan	10-Q	10.36	08/11/15	
10.36.1	Form of incentive stock option award under the 2015 Omnibus Equity Plan	10-Q	10.36.1	08/11/15	
10.36.2	Form of nonqualified stock option award under the 2015 Omnibus Equity Plan	10-Q	10.36.2	08/11/15	
10.36.3	Form of restricted stock award under the 2015 Omnibus Equity Plan	10-Q	10.36.3	08/11/15	
*10.37	2015 Director Equity Plan	10-Q	10.37	08/11/15	
10.37.1	Form of nonqualified stock option award under the 2015 Director Equity Plan	10-Q	10.37.1	08/11/15	
10.37.2	Form of incentive stock option award under the 2015 Director Equity Plan	10-Q	10.37.2	08/11/15	
11	Statement of re-computation of per share earnings	See Note 6			
		of			
		Financial			
		Statements			
31.1	Certification of the Chief Executive Officer under Rule 13a-14(a)				ü
31.2	Certification of Chief Financial Officer under Rule 13a-14(a)				ü
32	Section 1350 Certification of Chief Executive Officer and Chief Financial Officer required under section 906 of the Sarbanes-Oxley Act of 2002				ü

101 The following materials from Cortland Bancorp's Quarterly Report on Form 10-Q for the quarter ended September 30, 2016, formatted in Extensible Business Reporting Language (XBRL): (a) Consolidated Balance Sheets; (b) Consolidated Statements of Income; (c) Consolidated Statements of Comprehensive Income; (d) Consolidated Statements of Changes in Shareholders' Equity; (e) Consolidated Statements of Cash Flows; and (f) the Notes to Consolidated Financial Statements tagged as blocks of text and in detail (included with this filing)

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(1) Film number 06691632

\* Management contract or compensatory plan or arrangement

\*\* SEC File No. 000-13814

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CORTLAND BANCORP AND SUBSIDIARIES

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CORTLAND BANCORP

(Registrant)

/s/ James M. Gasior  
James M. Gasior

Date: November 10, 2016

President and

Chief Executive Officer

(Principal Executive Officer)

/s/ David J. Lucido  
David J. Lucido

Date: November 10, 2016

Senior Vice President and

Chief Financial Officer

(Principal Financial and Accounting Officer)